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THE U.S. ECONOMIC OUTLOOK

HEARING

BEFORE THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED SEVENTH CONGRESS

SECOND SESSION

ON

THE CURRENT ECONOMIC OUTLOOK IN THE SHORT- AND LONG-TERM; PREDICTIONS CONCERNING THE ROBUSTNESS OF THE ECONOMIC RECOVERY; EFFECTS OF INCREASED UNEMPLOYMENT; CONTINUED WEAKNESS IN THE GLOBAL ECONOMY; AND RECOMMENDATIONS FOR MONETARY AND FISCAL POLICY

MARCH 12, 2002

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C O N T E N T S

TUESDAY, MARCH 12, 2002

WITNESSES

THE U.S. ECONOMIC OUTLOOK

TUESDAY, MARCH 12, 2002

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:15 a.m. in room SD–538 of the Dirksen Senate Office Building, Senator Paul S. Sarbanes (Chairman of the Committee) presiding.

OPENING STATEMENT OF SENATOR PAUL S. SARBANES

Chairman SARBANES. The hearing will come to order.

I am pleased to welcome before the Committee this morning this distinguished panel: Robert Solow, Professor Emeritus of Economics at MIT and a Nobel Laureate in Economics; Joe Stiglitz, Professor of Economics and Finance at Columbia, and recipient last year of a Nobel Prize in Economics; Alan Krueger, the Benheim Professor of Economic and Public Affairs at Princeton; and David Malpass, Chief Global Economist for Bear Stearns & Co., Inc.

Actually, all of these witnesses are well-known to the Committee and to Washington. Professor Solow, of course, has testified before Congress many times. Joe Stiglitz served as Chairman of the Council of Economic Advisers under President Clinton, Chief Economist at the World Bank. Alan Krueger served as the Chief Economist at the Labor Department in the mid-1990's. And David Malpass was at the Department of the Treasury under Presidents Reagan and Bush. He was also the Staff Director of the Joint Economic Committee of the Congress.

I want to thank all the witnesses for appearing today and for the care and effort they took in preparing their written remarks. Your full statements will be included in the record.

I was going to make a few comments about the current economic situation, but I think I will save that until the question period.

Before yielding to Senator Carper, though, I do want to note with great sadness and with very deep respect the passing yesterday of James Tobin, really one of our Nation's preeminent economists, a man who I knew. I knew him well and he was a man of extraordinary ability and great civility, and very fundamental decency. He had very strong views about public policy, but he put them forth in a way that led to really a very rational and reasonable debate I think with others. And I think he had a profound influence on the thinking in this country.

I actually was Administrative Assistant to Walter Heller when he was Chairman of the Council of Economic Advisers under Presi-

dent Kennedy. Jim Tobin was a Member of that Council, perhaps one of the most distinguished, certainly amongst the most distinguished that we have had.

Senator Carper.

COMMENTS OF SENATOR THOMAS R. CARPER

Senator CARPER. Thank you, Mr. Chairman. I had not heard of Dr. Tobin's passing until this moment. He was one of those people who could disagree with you without being disagreeable.

Chairman SARBANES. That is for sure.

Senator CARPER. Any number of times, I remember him sitting in forums in the House and the Senate like this and providing his guidance and counsel to those of us who were fortunate enough to be in the room with him.

I just want to thank our witnesses today for joining us. I had a chance to welcome you individually and would do so collectively.

David Malpass, who used to work for Bill Roth, my predecessor from Delaware, we are especially glad that you are here today.

I will be slipping out in a little bit. We are taking up the energy bill, as we wrestle with developing a comprehensive energy policy for our country and we are anxious to make progress on that today and certainly this week starting this morning at 10:30 a.m.

You are here really right after we passed an economic stimulus package last Thursday. Some have said that it is a day late and a dollar long.

[Laughter.]

Time will tell if we have, indeed, spent money that we did not have for a recession that is over. Maybe you will have some thoughts on that today.

We are glad you are here and we look forward to your testimony. Thanks very much.

Chairman SARBANES. Thank you, Senator.

Dr. Solow, we would be happy to hear from you and then we will go right across the panel.

STATEMENT OF ROBERT M. SOLOW NOBEL LAUREATE IN ECONOMICS, 1987 PROFESSOR OF ECONOMICS MASSACHUSETTS INSTITUTE OF TECHNOLOGY

Dr. SOLOW. Thank you very much, Senator Sarbanes.

I want to add my word about Jim Tobin, whom I worked at the Council when Senator Sarbanes was Walter Heller's Assistant. He was a role model for all of us from my generation and others, and a person of remarkable integrity. Someone once asked me whether he would be a suitable person for a very delicate and responsible job. My response was that whenever I find myself having to make a hard decision as between right or wrong, my universal method is to ask myself what Jim Tobin would do, and do exactly the same. It is too bad that you cannot be hearing from him today.

I am going to just comment briefly on a couple of important points that were raised in the written statement that I turned in, without trying to read it all.

This is, after all, a Senate Committee. We should be thinking about fiscal policy.

There is a problem with fiscal policy. It takes too much time to make decisions. It is hard to avoid getting those decisions mixed up with the search for political advantage. The decisions that are made in fiscal policy are often not easily reversible if the facts change. And that creates a problem in using fiscal policy devices in the business cycle context in the short run, just as was mentioned by Senator Carper.

The current stimulus package is an excellent example. The bill that finally passed last Thursday was an okay bill, though it could have been better and it should certainly have been much quicker. If it had been a term paper, I would have graded it a "B," but I would have penalized it for being handed in late.

The contrast with monetary policy is, of course, very strong. Monetary policy is much more flexible, at least in some hands, at least in the United States in some hands. It is more reversible when facts change, when our reading of the economic situation changes. And so, monetary policy is generally accepted to be a more suitable way to do tactical economic policy, short-run-oriented tactical policy. I had hoped that we were getting to the point where we could call more on fiscal policy, but the recent episode is not an optimistic indication on that point.

We used to get a lot of help from what are called automatic stabilizers, from the built-in tendency for the Federal budget to move sharply toward surplus in a strong boom and to move just as sharply toward deficit in a sharp slump. The automatic stabilizers were a very important part of fiscal policy 30 years ago, or 40 years ago. They are especially important because no one has to act and no one has the opportunity to obstruct. They happen automatically.

The strength of the automatic stabilizers in our economy has been weakened over the years, not on purpose, not as a deliberate decision, but because the mechanisms on which those automatic stabilizers rest have changed. Cyclical transfer payments are a smaller part of our economy now than they used to be. State and local governments are a larger part of government purchases of goods and services these days than they used to be, and State and local governments are statutorily not able to conduct their own fiscal policy in a counter-cyclical way. The general reduction in tax rates and the diminishing importance of corporate profit tax revenues in the total budget—I am not now speaking about whether that is a good thing or a bad thing—only that those are the mechanisms that used to make the Federal budget very sensitive to economic conditions and make it less sensitive now. The automatic stabilizers are not likely to get stronger, so we are not going to be able to rely on them in the way that we used to.

One possibility—this is a theoretical possibility that appealed to Jim Tobin and to me 40 years ago—would be for Congress to legislate once and for all a standard stimulus package which would be effective and temporary and politically neutral; the same package could work in reverse as a standard sedative package. Congress could then turn this package, and only this package, on and off by straight up-or-down votes when the situation called for it.

You could arrange such a package at a number of levels—weak, moderate, strong. It could be triggered by events or proposed by the President and then subject to an up-or-down vote by the Congress.

I realize that won't happen. I know that. But it is what would be needed as a substitute for the automatic stabilizers if we are to turn fiscal policy into a tool for countering the business cycle.

The next point I want to make is a very different kind. Think how uncertain we have been over the past few months about whether there was or wasn't a recession. If there was one, when did it begin? When will it end? Where are the next few months going to go? The four of us sitting here could go back and forth on that for days, weeks.

That cannot be the right intellectual background for conducting macroeconomic policy, especially fiscal policy. There is simply too much noise and too much nonsense in trying on the basis of yesterday's data to predict next week's economy. Here is an idea that will be very familiar to Senator Sarbanes because Jim Tobin and Art Oakun and I and others were talking about it when he was at the Council of Economic Advisers.

It would make much more sense and be much more relevant to look at the concept that we call potential output, potential GDP. It is the number we come up with when we ask: What is the economy's capacity to produce with reasonably full use of its resources? Our focus should be to compare where we are now with where potential GDP is. That would be a far better indicator of which way fiscal policy should be pushing.

In the written statement that I have submitted to you, I point out that real GDP now is right about within a percent or so of where it was a year ago, the beginning of 2001, or 2000. And by the standard estimates of what has been happening to potential output on which the current Council of Economic Advisers and the Congressional Budget Office and private economists like myself tend to agree—by those standards, we have built up slack, room for expansion in the economy of about 4 percent of GDP.

If the economy grows at 3 percent during the four quarters of this year, which is what the standard forecast right now is, we will not cut into that gap at all. We will still in the first quarter of 2003 have room for expansion amounting to 4 percent of GDP.

By the way, many people, including on Mondays, Wednesdays, and Fridays met, thought that 2 years ago, when the unemployment rate was down to 4 percent, we were maybe a little too close to the risk of inflation.

That is okay. One could make that adjustment in the kind of thinking that I am suggesting, and still get a much clearer picture of where the economy stands relative to where we should want it to be, and to use that as an indicator of what we should do.

That is not a foolproof way of making fiscal policy or monetary policy or anything else. Nothing is. But the raw materials are there both within the Government and outside the Government. By going back to thinking in those terms, we would avoid a lot of intellectual wheel spinning.

That is why I was content to give the stimulus package a B. Even having been handed in late, the stimulus package was a good idea; and this has nothing particular to do with there never having been a recession or the recession already having been over or being the only one-quarter recession in the history of mankind or that thing, but because there is room for the economy to expand.

I want to say just one last sentence: As I read Alan Greenspan's testimony before this Committee last week, it was not in contradiction to what I have just been saying. Mr. Greenspan spent a lot of time waffling over what happened last week and what will happen next week. Waffling is what that kind of conversation calls for and he is a master of it. But the general picture of where the economy is relative to a reasonable standard we might set is certainly consistent with what I have been saying. I think that what we have to hope for from monetary policy is that we will get the same kind of flexibility, nondoctrinaire flexibility, in dealing with the next year or two that we did get to our great advantage over the past 4 or 5 years from the Fed.

Thank you very much.

Chairman SARBANES. Good. Thank you very much.

Dr. Stiglitz.

STATEMENT OF JOSEPH E. STIGLITZ
NOBEL LAUREATE IN ECONOMICS, 2001
PROFESSOR OF ECONOMICS AND FINANCE
COLUMBIA UNIVERSITY

Dr. STIGLITZ. Thank you, Mr. Chairman.

I want to begin by seconding what Professor Solow just said, that the critical issue is not the one that has been focused upon, but whether the recession is over or not.

The real point is that the economy for the last year has been performing substantially below its potential. I think that there is absolutely no doubt about it. And if we go from minus one-half a percent to plus one-half a percent, it is still performing substantially below its potential. Even the most optimistic people do not see any change in that prospect, that it was very likely to perform below potential.

The numbers that I talked about in my written statement are substantially more conservative than those of Professor Solow. I talked about a 3 percent GDP shortfall. But one should try to remember what that entails. In a $10 trillion economy, a shortfall of 3 percent is $300 billion per year. If it goes on for 2 years, we have lost $600 billion. That is an enormous wastage of resources.

The consequence also is that there is unemployment. Alan will talk a little bit more about the unemployment problem. But even as the economy in this recession—if it is true—ends, long-term unemployment has remained high. And the suffering that that causes is significant.

The step that was made to finally—and again, too late—provide for extended benefits last week was an important step in the right direction. But it only extends for 1 year and there is little prospect that the long-term unemployment problem will be resolved in the course of a year.

I wanted to move on and talk a little bit about the nature of this current economic downturn and the reason why I am not optimistic that there will be a robust recovery.

In my written testimony, I talk about the number of negative factors. I go through each of the major categories of expenditure—consumption, capital expenditure, exports—and explain why I think that the prospects of a robust recovery are limited.

I note that the one positive from a macroeconomic point of view is the increased expenditures in military. That does help sustain economic recovery. But I emphasize there that unlike investments in education or roads, they do not contribute to long-term economic growth. They are a utilization of resources that does not promote the long-term economic strength of our economy. And one needs to take that into account when one looks at the overall long-run picture. A lot of what I am going to be saying is focusing on the medium- and long-term.

I want to move on in my discussion to address the sources of our current problem.

I believe that if we are to formulate policies aimed at enhancing the strength of the economy in the middle- to long-run, we must understand better the sources of our current downturn, of the massive under-performance of the U.S. economy.

While every boom comes to an end, there are lessons to each. Earlier booms and the busts that follow taught us the dangers of inflation and the effects have been too hard on the brakes to stop it. The recession of 1991 can ultimately be traced back to the weaknesses in the financial sector. Those in turn impart to the excessive deregulation of the 1980's. I am not sure that we have learned the lessons of excessive exuberance of the late 1990's.

In some ways, it is a familiar pattern. Deregulation in a sector—here telecommunications—leading to excessive investment in that sector, in this case, the problems exacerbated by breathtaking technological developments and—I want to emphasize this—deregulation in the financial sector.

The Glass–Steagall Act was concerned with the problems raised by the conflicts of interest. It was foolhardy to think that such behavior would not reappear with its repeal.

At the time I served on the Council of Economic Advisers, we raised strong concerns about conflicts of interest and problems in accounting standards and practices, particularly as they related to derivatives and options. Our concerns have proved to be on the mark. There were, of course, others who raised similar concerns. Arthur Levitt was right in calling attention to these conflicts of interest in accounting firms when they simultaneously provide consulting services.

The FASB called for a changing of accounting practices to more accurately reflect the costs of options given to executives.

I have devoted much of my academic life to the economics of information, and to the consequences of imperfections of information. The proposed revisions would have improved the quality of information. To be sure, some firms' economic prospects might have looked worse as a result, and its stock market price might have fallen as a result—as well it should.

It was inevitable that a day of reckoning would come. Providing misleading information only delayed the day of reckoning. But worse, it led to a massive misallocation of resources, as overinflated stock prices led to the excessive investment which is at the root of the economic downturn.

Some contend that it is difficult to obtain an accurate measure of the value of options. But this much is clear—zero, the implicit value assigned under current arrangements, is clearly wrong, and

leaving it to footnotes to be sorted out by investors is not an adequate response, as the Enron case has brought home clearly.

If we are to have a stock market in which investors are to have confidence, if we are to have stock markets which avoid the kind of massive misallocation of resources that result when information provided does not accurately report the true condition of firms, we must have accounting and regulatory frameworks that address these issues.

I am convinced that leaving it to the market will not work. I served on an SEC commission on valuation on which Ken Lay also served. Many on that commission believed that leaving it to the market was the view of many of those, and I think we see perhaps why and certainly the consequences.

As derivatives and other techniques of financial engineering become more common, these problems too will become much more pervasive. While headlines and journalistic accounts describe some of the inequities, those who have seen their pensions disappear as corporate executives have stashed away millions for themselves, what is also at stake is the long-run well-being of our economy. The problems of Enron and Global Crossing are part and parcel of the current downturn.

So, I want to emphasize that, while typically, macroeconomics focuses on macroeconomics, there are important microeconomic foundations to the problems and, as is often the case, this is the case today.

In the limited amount of time, I want to spend a few minutes talking about a couple of particular issues. The first is the tax cut.

When we were talking about fiscal policy in the early 1990's, 1993, 1994, the economy was facing an economic downturn. We focused very much on the question of what was called a low-cost stimulus. How to stimulate the economy using fiscal measures and at the same time having a minimal budgetary impact.

My view is that the tax cut that was passed by Congress in the spring was extremely badly designed. It provided very little stimulus to the economy, at the cost of a substantial adverse effect on the overall fiscal position of the United States. The result is that, while short-term interest rates have come down significantly, long-term interest rates have come down very little. And many people believe it is the long-term interest rates which are more relevant for investment.

One of the reasons that many people do not see a strong, robust recovery is precisely because there has not been that decline in long-term interest rates. That means, looking forward, that there should be a certain degree of pessimism.

As I point out in my written testimony, there are tax reforms that, for instance, would have done far more to promote investment in the short-run with far lower budgetary costs, like the net investment tax credit, and better income-averaging provisions.

Both you and Professor Solow talked about the legacy of Jim Tobin. One of his legacies was the investment tax credit. And that was one of the sources of economic growth that began in the 1960's. We now know how to even improve upon that through a net investment tax credit. That was not the stance that was taken. It was really much more corporate giveaways rather than trying to design

a tax reform that would have been good for the overall performance of the economy.

I strongly side with those who believe that when one makes a mistake, one should recognize it. It is not just the size of the tax cut that was a mistake, but its design. Given the peculiar structure of the tax bill, with provisions that expire in 10 years, it is inevitable that the issues will have to be revisited. It is better that that be done sooner than later.

As you all know, I have spent a lot of time in the last 4 years involved in foreign economic policy and I want to spend a few moments talking about that because it is related to our current macroeconomic situation.

One of the sources of strength of the U.S. economy during the 1990's was increased export to emerging markets. This was partly a result of trade opening, partly a result of the robust economy in those regions.

Mismanagement of international economic policy by the IMF has contributed significantly to a worsening of prospects, and I think that will have adverse effects not only on the political position of the United States and how it is perceived around the world, but also on our economic prospects.

It is also the case, let me emphasize, that the problems that we face in our exports are caused largely by the strength of the dollar. And the strength of the dollar, in turn, is caused by our macroeconomic stance.

In the early 1980's, a large tax cut was enacted, and that led to a massive worsening of the fiscal situation. The trade deficit is simply the difference between what we invest and what we save. National savings—including public savings—has gone down from what it otherwise would have been. The trade deficit would have been even worse, were it not that investment too has gone down. But when our economy recovers, investment will increase, and with it, there is a good chance that the trade deficit will worsen.

We should be clear—it is not protectionist policies abroad or unfair trade practices or just the failed macroeconomic policies that have caused our current trade deficit problems. Whether they get reflected in the steel industry, the automobile industry or elsewhere, it is our overall macroeconomic framework, including the tax cut that was passed last May. And I suspect that the full adverse effects of the tax cut on our international economic position are yet to be fully felt.

You mentioned that you were going to have a vote on energy policy, and let me just make a few brief remarks. I think that this is important for the long-run economic prospects of the economy.

There is a widespread agreement among economists that GDP does not provide a good measure of economic well-being. At the very least, we should take account of the degradation of the environment and natural resources. Bad information systems can lead to bad decisionmaking, as we have recently seen in the corporate world, and I referred to that earlier.

Nowhere is this more true than in energy policy. Extraction of oil and natural gases may increase our measured GDP, but it does not increase our economic well-being commensurately.

We should take account of the depletion of our resource base and the degradation of our environment as a result of carbon emissions. An energy policy which focuses on drain America first is not even good for our long-run national security, for it leaves us potentially more vulnerable in the future. Long-run economic growth—correctly measured—and long-run security both suggest that we should focus more on conservation. And basic principles of economics suggest that what is required is incentives. Why should we think that moral suasion would be more effective in this arena than it is in any other area of economic activity?

I want to conclude with a few remarks about one of our long-term problems—our Social Security system.

That program has been an enormous success. We have brought the elderly out of poverty and we have provided a new measure of economic security to the aged. Transaction costs are low. Improvements in the design of the program over the years have reduced some of the unintended inequities, reduced any adverse effects it might have on labor supply, and increased overall efficiency. There is still a way to go to put it on sound financial grounds.

Economics is traditionally described as the science of choice. The legacy of the Clinton years, a huge fiscal surplus, provided us with an opportunity to make some choices. We could have used some of these funds to put the Social Security system on sound financial ground. We could have fully funded that system. We could have decided on how to proceed in the future. We have largely squandered that opportunity.

Proposals for partial privatization typically leave the fiscal situation of our Social Security system worse off. Any reform proposal which does not begin by addressing the question of how current unfunded liabilities are to be financed is irresponsible, and should be a nonstarter.

Elsewhere, I described at greater length common myths concerning Social Security. One that has recently received some attention is the low return on Social Security accounts. We should be clear—Social Security funds are invested well, but conservatively. To the extent that capital markets work efficiently, then any higher returns that might be received would simply reflect higher risk.

It is imprudent for those approaching retirement to invest all, or even most, of their assets in highly risky investments. If there were a decision to undertake greater risk, the public Social Security system could do so, again, at low-transactions costs.

Just to put things into perspective, the transaction costs in the privatized part of the British system have been estimated to reduce benefits by 40 percent from what they otherwise would have been. This is how privatized systems work.

Part of the reason that in partial pay-as-you-go Social Security systems, it appears that returns are low is that some of the returns are used to bear the costs of the unfunded liabilities. The problem of funding those unfunded liabilities does not go away with partial or complete privatization. It will have to be borne elsewhere.

To assess the merits of any reform proposal, therefore, one must know how, and who, will bear those costs. To do otherwise is dishonest. It may put in jeopardy the long-run prospects of our economy, for a day of reckoning will undoubtedly come.

Let me conclude by saying that I continue to believe that the basic fundamentals of the U.S. economy remain strong. But I have seen the fortunes of countries change quickly as a result of economic mismanagement. The decisions, the choices, we take today will affect not only economic performance during the next year, but also our long-run prospects.

I believe that the tax cut that was enacted last spring was based on a serious miscalculation of our economic situation. It is a decision which, however, is reversible. If we do not revisit the issue, in the light of the new information which has come to light and the new situation which has evolved, the damage which could be done may itself be irreversible—or at least it will take a long time to undo it. Much is at stake.

Thank you.

Chairman SARBANES. Thank you very much.

Dr. Krueger.

STATEMENT OF ALAN B. KRUEGER
BENDHEIM PROFESSORSHIP IN
ECONOMICS AND PUBLIC AFFAIRS
PROFESSOR OF ECONOMICS, PRINCETON UNIVERSITY

Dr. KRUEGER. Thank you, Senator Sarbanes. I appreciate the opportunity to talk about the economy this morning.

Let me begin by seconding Joe Stiglitz and thirding Bob Solow by saying it is not very productive to debate whether there was a recession. It is quite clear looking at the labor market that the labor market turned down in 2001 and March marked the turning point in the labor market.

The unemployment rate reached a 30 year low of 3.9 percent in April 2000. It hugged pretty close to 4 percent until the end of 2000. March 2001, the unemployment rate stood at 4.3 percent. Then it increased to 4.9 percent by August 2001, before the September 11 attacks, and reached a recent high of 5.8 percent 2 months ago. The last 2 months, the unemployment rate has ticked down a bit to 5½ percent.

I think it is a bit too premature to celebrate the recovery in the labor market. In terms of employment, 1.4 million jobs were lost in the 11 months since March 2001, and 1.8 million jobs were lost in the private sector. If we compare that to the recession in the early 1990's, 11 months after the start of the recession in 1990, 1½ million jobs were lost in both the private sector and in total.

This downturn has not been less mild as far as job losses is concerned. In fact, if we compare the total job loss in the recession in the early 1990's, even in the period after the recession ended when jobs continued to drift down, total job loss in the private sector was 1.8 million jobs then and 1.8 million jobs now.

So in terms of job loss, as I said, this recession so far has been about as severe as the one in the early 1990's.

This recession seems to me to have two distinct phases in the labor market. The first phase was quite a surprise. Ordinarily, in a downturn, less skilled workers and minorities are the hardest hit.

In the first 4 months of this recession, from March to July of 2001, the unemployment rate actually increased more for highly skilled workers than for less skilled workers. So for college grad-

uates, the unemployment rate increased from 1.9 to 2.2 percent. For high school drop-outs, the unemployment rate held steady at 6.8 percent.

I have to say that that was quite a surprise to those of us who watched the labor market. By past history, we expected the labor market to turn down more quickly for the less skilled and also because of welfare reform, I certainly expected that those last hired would have been the first fired and thought we would see more difficulty among the less skilled at the beginning of the recession.

Well, since the summer, the typical pattern has emerged.

From July to February, the unemployment rate has risen much more for the less skilled than for the highly skilled. And these numbers are reported more fully in my written statement. But the unemployment rate for high school drop-outs increased from 6.8 percent in July, up to 8.3 percent last month.

I should also add, while the overall unemployment rate went down last month, an amount that was not statistically significant, the unemployment rate did increase for high school drop-outs last month. So the situation does not appear to have turned around for the less skilled.

Meanwhile, the unemployment rate in the last 7 months increased for highly skilled workers, but not by as much as it increased for the less skilled.

So if you look over the whole period of the downturn, the unemployment situation has worsened more for less educated workers than for more highly educated workers, as is the typical pattern. And we get a similar picture if we look by race. It looks like there were two phases.

In the first phase, the unemployment rate increased for white workers and actually fell for black workers, which was again quite a surprise. And then in the second phase, the unemployment rate has been rising more for black workers than for white workers.

Now the usual pattern is for unemployment to linger at a high level after a recovery begins. If we go back to the experience in the early 1990's, the unemployment rate stayed high and continued to rise for 15 months after the recession officially ended.

There are several explanations for why jobs are slow to grow after economic growth resumes. One is that employers are simply uncertain how long the conditions will last. I think all of us here are uncertain what type of a recovery we are about to have. That naturally leads employers to be cautious in terms of hiring and rehiring workers.

Another explanation is called labor hoarding. During a recession, firms will sometimes hold onto workers, particularly those who they invested a lot in their training, because it would be costly to rehire workers with such skills after the recession ends.

Another factor is called upskilling of positions. Employers often will raise the standards for jobs in a recession and will hire highly skilled workers to do the kind of work that previously was done by less skilled workers, and not until demand increases rather smartly will they adjust the standards and begin to hire the less skilled workers again.

Then, finally, I would add that recessions give firms an opportunity to reorganize, to rethink the way they do things and change

the way they do things. And that often leads them to prefer to hire more highly skilled workers than less skilled workers because more highly skilled workers are more flexible. This also dovetails with the purchase of new equipment, implementing new equipment, which tends to go hand-in-hand with more highly skilled workers.

So, looking forward, my guess is that the soft labor market situation will linger for a while. That has been the past practice. Also, if you look at the numbers and say, well, suppose the recession ended in the fourth quarter of 2001, which is a reasonable guess at this point. Well, then, it has been the case that unemployment has continued to climb for the less skilled workers and climbed overall since the recession ended because it is higher now than it was in the fourth quarter of 2001. But I have to confess a fair amount of uncertainty in this prediction that unemployment will remain stubbornly high, even if we are in the midst of a recovery.

The first reason for my uncertainty is that the beginning of this recession was unusual. I am somewhat heartened in the sense that I see a familiar pattern in what has happened since the summer. But one does have to admit that different forces do seem to be at work in this recession, as Joe pointed out earlier.

Another difference is that productivity growth has remained strong in this recession, stronger than is ordinarily the case in a recession. And that might imply that there has been less labor-hoarding, that firms might be leaner coming out of this recession than is typically the case and they might be quicker to expand employment.

And that leads me to the third factor which might lead the labor market to recover sooner than is usually the case.

It seems that we have gone through some fundamental changes in the labor market, that the way in which employees find jobs has changed over the last 10 or 15 years. Unfortunately, the data are not terrific, but it looks like the number of vacancies at a given unemployment rate is lower than it used to be, and there are several hypotheses for why that is the case. One explanation is that temporary help firms make the labor market more efficient, speedier in terms of placing workers, make it easier for firms to adjust to hire workers, and also make it easier for them to reduce their workforce. There is also more outsourcing. And I suspect that the web has changed things. A remarkably high number of people search for work by looking at Internet job boards and using techniques that did not exist even 10 years ago.

In spite of these factors, my best guess would be that the labor market will remain soft, even if we are in the midst of a recovery.

What I think is probably most important to bear in mind for policy, at least in the short run, is that, to avoid a jobless recovery, we should look at what kinds of options we have to increase employment for less skilled workers.

The unemployment rate is much higher for less skilled workers. It is been growing for less skilled workers relative to more highly skilled workers. And if we are to reduce unemployment further, I think it will come mainly from reducing unemployment for less skilled workers.

Now, Bob Solow mentioned that fiscal policy in this instance has been slow to respond. I think I certainly agree with that. I remain

somewhat optimistic that if the recession was more severe, fiscal policy might have been a bit quicker. But fiscal policy does come with the types of problems that Bob mentioned.

And that leads me also to discuss automatic stabilizers. I commend the Congress for extending unemployment benefits, although I think Bob Solow's is a softer grader than I am. I do not know if I would have given a "B." I think more could have been done in this situation.

One thing would have been to expand benefits for workers who seek part-time jobs. Part-time employees pay into unemployment insurance. Yet, in most States, they do not qualify for benefits.

I think for stabilizing the economy, another more important point is that the automatic stabilizers built in for extended benefits to kick in are no longer realistic.

The insured unemployment rate in a State must exceed 5 percent and then some other conditions have to be met for extended benefits to turn on. The trigger used to be 4 percent in the 1980's. It increased to 5 percent. Since then, the insured unemployment rate relative to the overall unemployment rate has drifted down.

In other words, the unemployment insurance extended benefits and the automatic triggers rely on the fraction of people who are receiving benefits, receiving unemployment benefits relative to the workforce rising, but the take-up rate for unemployment insurance has declined and because of that, it makes it much harder to reach the automatic triggers. Moreover, the national rate of unemployment appears to have declined, which also means that the triggers are beyond reach, even with the fairly substantial increase in unemployment.

I think one fairly straightforward thing to do would be to lower the triggers for State benefits to turn on. That way, it wouldn't be necessary for Congress to deliberate in a downturn whether it is necessary to extend benefits. And I think that if extended benefits were available more quickly, it would shorten the length of downturns and could also save money because it wouldn't be necessary to extend benefits nationwide, but they could be targeted more to the States which are suffering the most.

Some other changes in unemployment insurance which I think would also be important would be to improve the experience rating in the system. Employers are supposed to pay a higher tax rate if they have had a worse record laying off workers. In a number of States, experience rating has lapsed. There are very few rates. Some States, only two rates.

In essence, what we are doing is subsidizing employers who lay off workers. We are subsidizing them by providing benefits to their workers when they lay them off and we are not charging the firms for those costs.

Then I would also add that the taxable base for unemployment insurance in many States is quite low. The taxable base in the majority of States is between $7,000 and $10,000, which means that for higher-income people, they do not pay any unemployment insurance tax after their first $10,000. This leads to very regressive financing. And if we were to raise the tax caps, we would be able to lower the rates, which I think would have a favorable impact on employment demand.

Let me conclude by saying that I think this is a time to think about how we can make Government policy respond more quickly in the event of a downturn. One of the most important automatic stabilizers we have now is the tax system, not by design, but just the way it works.

Progressive taxes work as an automatic stabilizer. If income falls, people fall into lower tax brackets. So, I think it is important to bear in mind that this is one aspect of progressive taxation.

I think another policy to consider at this point would be job training, how that connects with unemployment insurance. Funding sufficient job-training programs, especially for youth, which were cut during the Clinton Administration and the Bush Administration has proposed cutting even deeper.

Last, I would just add that I think it is important that we think about these policies in the context of a budget that is sustainable and a budget that is forward-looking and helps us to prepare for the retirement of the baby boom generation.

Chairman SARBANES. Thank you very much.

We will now turn to David Malpass, the concluding panelist.

STATEMENT OF DAVID R. MALPASS
CHIEF GLOBAL ECONOMIST
BEAR STEARNS & CO., INC.

Mr. MALPASS. Mr. Chairman, I want to thank the Committee for the opportunity to make a statement today. My written statement covers the economic outlook and gives some thought on U.S. monetary and fiscal policy. It also includes a final section dealing with some foreign economic policy issues.

I am going to use some of the graphs from the written statement, if you have one to look at while I go through.

I am the Chief Global Economist at Bear Stearns. So part of my comments for the Committee today also relate directly to the financial markets.

One of the global economic features of the 1990's was the sharp increase in the U.S. share of world GDP. Part of this is a tribute to our economic system, but another part reflects the relatively poor economic performance in Japan and many developing countries. As we count our many blessings and work to make our own economy better for all, I think it is in our interest to also spend considerable time and attention working on an appropriate U.S. international economic policy.

The first graph in my statement shows the nominal world growth rate in the 1990's. And what we can see is that in the first part of the 1990's, world nominal dollar growth was strong. Then in the latter half of the 1990's, it tailed off. Part of this is the strong dollar, but part of it also is the weakness of economies, particularly abroad.

As we think about the economic outlook, I expect a broad-based U.S. recovery in 2002, with support from consumption, inventories, Government purchases, and second-half strength in business investment. The U.S. economy's natural tendency is to grow. The latest improvement in the outlook over the last couple of weeks is justified, in my view, by the solid U.S. strengths—strong productivity growth and relatively full employment.

And I will go into that in a moment.

In recent months, Americans have shown their optimism and their patience when confronted with adversity, traits that I think auger well for the recovery.

After some recessions, growth accelerates to high levels early in the recovery due to pent-up demand. I do not expect that pattern in this recovery. The second graph in the statement shows the consumption rate in this period versus the average recession. And what we see is that you can barely see that there was a recession if you just look at the consumption growth this time around. It did not dip the way it normally does in a recession.

In many ways, the economy is reacting as if it is enjoying relatively full employment. For perspective, we have today a 5.5 percent unemployment rate. At the end of the 1991 recession, in March, the unemployment rate was 6.8 percent. We are well below that. So in many ways, the economy and the consumption growth are responding to an unemployment rate that by longer-term historical standards, is relatively full employment.

Of course, I would like to see the unemployment rate substantially lower. Given the strong productivity growth, it is clear in my mind that the U.S. economy can again be able to enjoy a sub–5 percent unemployment rate without it being inflationary.

I am going to skip the housing section here and turn to corporate profits.

Even though the recession seems to be over, there are still intense pressures in the economy. I think they reflect the aftermath of a deflation caused by dollar strength in the late 1990's. We should in this environment see a piece-by-piece recovery unfolding in the economy, meaning that some industries, companies, and employee groups have absorbed most of the shock, while others are still in its grip.

In my view, the intensity of the corporate adjustment is pushing the economy quickly through the deflation process, that brings it closer to completion. This ability to digest mistakes and move forward is one of the hallmarks of the American system of business and labor flexibility and is a key factor in our strong, long-term growth rate.

The graph labelled Behavior of Profits in Recession shows that in an average profits recession, corporate earnings decline. In this profits recession, they have declined much more deeply than in an average profit recession.

So this brings me to some cautions, not in the statement.

As we look at why those corporate earnings have gone down as much as they have this time around, one of the reasons is that nominal growth rate is weak. Economists typically deal in real growth rates and that is appropriate for many times. But as we move into a very low inflation environment—in fact, recall that the GDP deflator in the fourth quarter was minus three-tenths of a percent of GDP. And nominal growth rate was lower than the real growth rate. So as we look at the nominal growth rate in this recession, it has been deeper, the slow-down has been deeper than in many previous recessions.

Another caution for us right now is that part of the strength in real GDP is related to the weather and also to the increased secu-

rity costs that we have had after September 11, and the Government spending that went along with them.

So these will all tend to be short-term or not long-term growth-creating factors for the economy. Those are some cautions looking forward.

I want to now turn to monetary policy, I offered a few thoughts in my prepared statement.

As the U.S. recovery broadens, U.S. monetary policy will be faced with the question: Is growth itself inflationary? And if not, does it require monetary policy response?

The graph shows that over the 1990's, the range of the short-term interest rates of the U.S. has been relatively wide as the Fed tries to respond to these growth swings.

My view is that inflation and deflation are more related to changes in the value of money—let's call it the strength of the dollar—than to economic growth. When a currency loses value, it puts upward pressure on prices. Likewise, when a currency rises in value, it puts downward pressure on prices. Since the dollar is very strong right now, as judged by several factors, and the graph shows the trade-weighted value of the dollar reaching a very high level in most recent years, I think there is more likely to be downward pressure on prices than upward pressure.

So even with a recovery, it looks as if CPI inflation will fall substantially in coming months and be low, relatively low, for the foreseeable future. This makes an argument against a rapid increase in interest rates and bond yields. As a policy matter, I would like to see a more explicit recognition of the connection between the value of the currency and the inflation or deflation rate that is expected. I think it is important for us to achieve stability in the value of the dollar as a step toward price stability.

In addition, I wanted to offer some thoughts on fiscal policy. It is obviously a very complicated subject, both from an economic and a political perspective. These are, therefore, very general thoughts.

It looks like the budget may now actually be in surplus or close to it in fiscal 1902, and also in fiscal 1903. This is the result of several positive factors. They include—a shallower-than-expected recession, the remarkable change in the interest rate policy in 2001, strong U.S. productivity growth, and also Congress unusually well-timed tax cut in 2001.

The Federal budget reflects tremendous growth in spending and even faster growth in Federal receipts. The graph in the text shows nominal spending and nominal revenues and you can see us trading back and forth between surplus and deficit.

Note that this graph is using CBO's February 1902 forecasts, the ones that they made last month, and I imagine if they reestimated the budget today, there would be a much smaller deficit showing, if any, for the fiscal year 1902 budget.

The budget outlook is very sensitive to growth assumptions. No one is very good at forecasting growth rates in either the near-term or long-term. I am skeptical of the process of trying to calculate potential GDP or using it as a rule or a guidepost for monetary policy because of this difficulty in actually projecting short- or long-term growth rates.

The bar graph in my statement shows the size of the miss by both CBO and OMB in the 1990's versus the actual growth rate. Year after year they systematically, under-estimated both the potential and the actual growth rates for the U.S. economy.

I should note that in the 1980's it would show the flip side. There was a systematic over-estimate of the growth rate by both agencies during that period of time. I think it makes it difficult to use this kind of projection as a guidepost for monetary policy.

If economic growth is as solid as I expect, then the glidepath for the pay-down of the national debt will be rapid and would not be, in my view, good economic policy. In effect, our current policy is to levy a stiff level of taxation on workers and the profitable portion of the private sector in order to pay off relatively low-cost Federal debt. The effect is to improve the Federal Government's balance sheet while putting pressure on the public's balance sheet.

Given the economic recovery, then, Congress will probably revisit the 1990's debate about what to do with the fiscal surplus. In my view, tax cuts would help maximize the growth rate and gains in median incomes. In addition, I think a fiscal surplus, if it emerges, should also provide an opportunity for an improvement in the Social Security system.

Finally, I wanted to offer some thoughts on international economic policy.

The U.S. economic recovery is good news for foreign economies. It will probably spark a recovery in Europe and may even help Japan break out of its deflation spiral. Some developing countries will be able to participate in the global expansion, helping them raise their living standards.

However, I am worried about the polarization of the world economy, meaning the wide gap between the U.S. growth rate and growth rates abroad. With each new burst of U.S. growth in the 1990's, it became increasingly apparent that the United States was producing and consuming an increasingly large share of world output. It reached roughly 35 percent and it is climbing. In my view, it is important that developing countries grow faster and begin to narrow the gap in global living standards, but very few are.

Over the years, I have advocated a rethinking of our international economic policy and the international financial institutions. I favor a vision of economic development based on stable currencies, lower tax rates, trade liberalization, and a firm belief that people at the bottom of the economic ladder should be able to move up. I do not think these principles are applied frequently enough in our international economic policy. My worry is that world growth may remain substantially below its potential, with the shortfall coming disproportionately from the poor.

In conclusion, Mr. Chairman, the likely U.S. economic recovery is very welcome, particularly given the war on terrorism and the turmoil in international affairs. The recovery provides a real opportunity for thoughtful economic debate. My statement noted the importance of monetary policy decisions relating to growth and inflation; fiscal policy decisions in the event of renewed surpluses; and the opportunity for constructive change in our international economic policy.

Thank you.

Chairman SARBANES. Well, thank you very much.

There is a vote going on and I have to recess the hearing briefly to go and vote. I think some other Members will also be joining us. So, we will resume in short order. The Committee stands in recess.

[Recess.]

Chairman SARBANES. The hearing will come to order.

I want to ask a couple of almost preliminary questions. First of all, the figure for the economic output in the fourth quarter originally came in at two-tenths of 1 percent. That was subsequently revised to 1.4 percent. And we had a big change in the productivity figure, too. Revised from an increase of 3.5 to 5.2 percent.

I have had an interest in these economic statistics infrastructure of the Federal Government. My own view is that we do not invest enough in it. We are talking about really small amounts of dollars. But we could substantially improve the infrastructure. I do not know if this is a good example of it or not. I guess that is the question I am leading into. But we start thinking about policy decisions off of one set of figures and then later we learn that the really accurate set of figures is something substantially different.

How much of a problem do you see this as being and how much attention should we give to it? That wasn't the purpose of today's hearings, but I would like to elicit some response on that.

Dr. SOLOW. It is a problem. Here we are talking about policy and the information on which our discussions and your decisions are based, is changing under our feet as we talk. Part of that could, I think, be helped by investing a little more in the data collection process that underlies the national accounts. Not all of it, however, can be helped that way.

For instance, part of the reason for the problem is that we rush the process. We want those summary numbers as soon as possible, or sooner. The quarter is barely over before we ask the Department of Commerce to produce the figures.

We need, I think, to realize early in the game, that the first numbers are going to be revised and can be revised substantially. But there is a lag in the collection of some numbers that could be shortened by spending, as you say, trivial sums of money by the standards of the Federal budget.

Dr. STIGLITZ. Let me make a couple of comments.

First, I agree with what Bob says that part of the problem is the fact that there are always going to be revisions. The first numbers are going to come in are going to be different from what next will be the case. At the same time, I think we have to recognize that the point that you made, the investment in this area is inadequate and that we could do better. When we get the revised numbers, they could be reliable. We could do better samples.

So, I think there is enormous room for improvement.

You focused on numbers of GDP and productivity. The flip side of that is the CPI, the cost of living, the inflation. It is very clear that productivity, when we revise upward productivity numbers, that revises downward the inflation and that means that the staffs at the Fed should be more conservative, and less concerned about inflation.

I always found it very interesting during the debates about revising the CPI in the context of Social Security, that while Greenspan

often talked about the implications that it had for the CPI, and for Social Security, there was less attention for the implications for monetary management. There were obvious implications, that we needed to be far less concerned about inflation than he and many of the other members of the board, Federal Reserve Board, seemed to be. And so, I think that this is very important.

A third point I want to make very briefly, which is I think the institutional framework for statistical collection should be changed. I think it would be desirable to think about establishing an independent statistical agency.

Chairman SARBANES. Like Canada?

Dr. STIGLITZ. Like Canada. Inevitably, the conflicts of interest between an operating agency and a data collection agency can be very great and lack separation.

At the international level, the problems are even greater. I think that the numbers that are reported for growth, for instance, for many countries by the IMF are simply made-up numbers to make their programs work and have nothing to do with scientific, economic-based forecasting, and that is not well known. I think that moving the statistical responsibilities out of the IMF would be a very important move in the right direction.

Chairman SARBANES. Alan.

Dr. KRUEGER. Let me mention, I started the survey center at Princeton, so these are issues that I have thought about quite a bit.

I would add that the private sector, as well as the Government, relies very heavily on the statistics that are coming out of the Bureau of Labor Statistics and the Census Bureau and the BEA and so on. And if you add up the costs of making mistakes for all those who are involved in using these data for decisions, it is enormous compared to the amount we are investing in collecting the data.

So, I have a couple of suggestions. I think there are some problems that could be solved by investing more to collect more information. And one of the problems is the economy has become harder to measure. The economy has become more diverse. Manufacturing now is a much smaller share. We are investing more in collecting the data, but the economy is getting harder to measure at the same time. So it is kind of a race where we are left standing in place.

One suggestion I have is that we should be more aware of the magnitudes of the revisions.

For example, in my written testimony, I pointed out that the employment growth last month was 66,000, according to the payroll survey. The typical revision from the first report to the third revision, which is 2 months later, is on the order of magnitude of around 50,000 jobs, plus or minus.

So when you think about these movements, you have to recognize that you need a wide confidence band around them. There are some numbers where you need a wider band than others. I think it would be helpful if the numbers were reported more frequently with those bands and if we think about those bands when we think about using the numbers.

But there are some critical areas where I think we just do not measure or we stopped measuring what is going on. One area has to do with vacancies. Bob Solow and I co-edited a book together. There is a lot of discussion on the relationship between vacancies

and the unemployment rate. We are forced to rely on help-wanted ads as a measure of vacancies. There are big changes in newspaper costs and in the way help-wanted ads are placed and so on.

The BLS has just revised or just started again a new survey on vacancies. But I think that that was a critical gap, and there are other areas where we are just not measuring enough.

Chairman SARBANES. David.

Mr. MALPASS. We maybe should have lower expectations of what we are really getting out of the data, because it is so complicated to actually measure what is going on in the economy.

Chairman Greenspan, in his testimony last week, mentioned again what he calls conceptual capital. In part, it is the human capital element of what is going into GDP. It is becoming more and more important. It is very hard to measure what that actually is, how productive it can be. So, I think we have to have some limits on what we can really expect from the data.

We probably all have individual statistics that we dislike the most. I will layout one domestic and one international that I think are misleading.

Personal savings is a statistic that we see every month. It gives us the impression that Americans are terrible at saving. That statistic produced by the Government is heavily biased. It keeps track of all the expenditures that people make, but doesn't keep track of all the income or cash flow savings.

For example, when someone refinances their home, say they save $200 a month in their payment and spend $100 of that. The Government keeps track of the spending. If they then put $100 extra every month into savings, we would think of it as their savings rate going up. But the Government's going to conclude that their savings rate actually went down by the $100 of spending. They do not record it properly.

We have the impression of a terrible performance by the American saver and it actually wasn't nearly as bad as that statistic.

On the international front, people focus on foreign direct investment as the solution for foreign economies. But what we find is that the data often comes from corporate reporting to a government that they want to please. The government comes to corporations and says, how much did you invest in our economy this year? And the corporation, of course, has an incentive to say a large number. It radically overstates the actual attractiveness. This is particularly true in some developing countries.

I agreed with what Joe Stiglitz said on the IMF producing a lot of data that really is just way off and is known to be off. That is part of their job, I guess.

Chairman SARBANES. Thank you.

Well, I have a number of questions, but my time has expired. I yield to Senator Bennett. I will come back.

STATEMENT OF SENATOR ROBERT F. BENNETT

Senator BENNETT. Thank you, Mr. Chairman. I appreciate your holding this hearing.

I look around the room for the hordes of visitors and observers and they are not here, which is too bad because I think the economy really is the starting place of virtually everything else.

One of the cliches that I repeat often and often again, and like most cliches, it happens to be true—money does not come from the budget.

We here in Congress forget that. We think we can pass a budget that creates a surplus or pass a budget that creates a deficit. We are always surprised. Nobody's prediction of what the fiscal year is going to produce is ever right or even close to right, except the one that is issued with only 1 month left in the fiscal year, and that is usually pretty close. But at the beginning of the fiscal year, we are always either overly optimistic or overly pessimistic.

Money comes from the economy. If the economy is doing extremely well, then we get surpluses that we did not predict. If the economy turns south, why, we get deficits that we did not predict. And too many people blame the predictors and do not realize that you are dealing with so many variables.

The example I like to use is a little like the weather forecaster. There are some who say, well, the weather forecaster is never right, so he cannot be any kind of a scientist. Actually, he can be a very good scientist. He is just dealing with so many variables that you have to cut him a little slack.

Economists get snorted at because their forecasts are never any good. Actually, I think you are scientific and you do pretty well.

With that having been said, let me raise an issue that came out of my exchange with Chairman Greenspan, when he was before us last week, that has to do with the role of capital gains and the amount of income that came from capital gains.

I made the observation to Chairman Greenspan that tax rates are at historic highs. They have never been higher as a percentage of GDP than they are now. He said, yes, that is true, except that we have had a tremendous amount of tax revenue coming from people cashing in on capital gains, and we have had some tax revenue on people cashing in on stock options. If you go below those to the income that comes from what one might consider more normal kinds of tax sources, the situation doesn't look quite so great.

Nonetheless, in macro terms, the tax burden on the economy is very high and the question is raised whether or not the economy over time can sustain a tax burden that is in excess of 20 percent of GDP, which we have not had. Does that produce some kind of a drag that will bring the economy down? And if it does bring the growth rate of the economy down—nothing's going to bring the U.S. economy down. We are not going to be Argentina. We are not even going to be Japan. But if our growth rate slows, then we are back into deficits rather than surpluses, however much we politicians would like to think we can control whether we are in deficits or surpluses.

If our growth rate slows, we are back into deficits rather than surpluses. We have other kinds of problems. I would like you to address that question of the overall 20 percent-plus tax burden that we have had. Then, if you would, in that, let's talk about capital gains because I view the capital gains tax as a tariff on money as it moves from one purpose to another.

And just to put it into simple terms that I can understand, I know an entrepreneurial type who is willing to invest his money in relatively high-risk activities because he has learned that they

produce high returns, and he has enough experience to pick, he believes, the right kind of high-risk activities.

When he is successful, and one such investment becomes much larger than it was when he got into it, he is loathe to unload it because if he takes his money out of investment A in an effort to put it into investment B, there is a tariff on the movement of the money, from A to B, in the form of the capital gains tax.

Now there is a widow who is most anxious to buy A because it is now a mature investment that is producing a stable and reliable 7 percent per year income, and she thinks that is just nifty.

He is very anxious to get out of A and into B because, for him, a mature investment that produces only 7 percent a year is a real drag. But the capital gains tax stands as a tariff barrier to prevent him from moving his money from A to B. And as we have lowered that tariff barrier, we have seen more and more money move from A to B, and in the process, produced the capital gains tax revenue that Chairman Greenspan was talking about.

So, I would appreciate your comment on those two issues.

Dr. SOLOW. I guess I will start. I am the oldest one here by a wide margin.

[Laughter.]

Senator BENNETT. As I am on this side.

[Laughter.]

Dr. SOLOW. I do not think that it makes sense to imagine that there is some natural upper limit to the ratio of Federal revenues to national income or GDP that we surpass temporarily or for a longer time at great peril, or that if we fall short of it, something else happens.

Much more depends on the nature of the taxes we levy, and the uses of the revenue that we collect, than on any simple statistic like the fraction of the national income that goes in taxes.

It is very important I think to focus on an obvious case: The need for national defense. If the safety of the country, the security of the country, requires expenditures that are naturally directed through the Federal Government, we will make those expenditures and we will tax for them if taxing is the rational way to finance them, and we will borrow for them if by any chance, borrowing is the rational method to finance them.

One problem with the illustration that Senator Bennett mentions is that it under-estimates the ability of the financial engineer to convert one form of income into another. In our tax system, we favor capital gains as against other forms of income, and as a result, there is a thriving industry of converting large salaries into asset transactions which appear as capital gains——

Senator BENNETT. If I could interrupt you. I have always heard the argument that, gee, you lower the capital gains tax and everybody will transfer their income into capital gains. I have never been able to do it. I have tried, and I have never heard of anybody being able to do it.

Dr. SOLOW. You do not hire a fancy enough tax lawyer and accountant. If, instead of being a poor but honest Senator, you were a rich movie star, or a rock star, I assure you that clever people would cluster around you who are anxious to do just that, for a mere tiny fraction of what they are going to save you.

Senator BENNETT. Yes, I know. And very often, they end up putting you into something that has wonderful upside protection and turns out not to be—like a percentage of your movie when you would have been better off by taking it in salary. There is always risk connected with the transaction.

Dr. SOLOW. Of course, there is always risk connected with any asset transaction. I am merely saying that you cannot simply look at the gross numbers without asking what incentives for the private economy, as well as for public servants, are created by different forms of taxation.

Alan Greenspan was right that, if you look at the numbers, when we passed through a period in which large asset gains are being realized and therefore, taxed, even if they are taxed at low rates, that will increase measured revenues. And they are not just measured revenues, they are real revenues of the Federal Government.

The lesson I would draw is that we should try, in thinking about public finance, to pay attention, more attention than we actually do, to the incentive effects of every tax increase, tax decrease, tax change, that we make, incentives that bear on businesses, bear on individuals, and to a certain extent, bear on the Government itself.

Senator BENNETT. Dr. Stiglitz.

Dr. STIGLITZ. Let me try to amplify a couple of points.

I agree with Bob that there are no magic numbers percent. It really depends in part on what you are doing with the money. For instance, we have done studies that show that the returns to investments in R&D by the Government have enormous returns, and we have not been investing enough in that area. So, my view is that if we spent more money on that kind of research, that would be a high-yield return that would help the economy grow.

We were talking about investments in statistical infrastructure. If the private sector is getting bad statistics, making bad decisions as a result, and spending more public money, that can yield very high returns.

The first point is what is the money going for? And we could obviously waste money. I am not going to tell you how to do that as well. But if we spend it well, it can yield high returns.

Second point, the design of the tax structure can make a great deal of difference. We can design tax structures that give strong incentives to people who are creative. We can give strong incentives to people who are engaged in tax shelters that are basically not creating value. And so, much of the concern about the debate of tax reform has been the design of tax structures that enhance productivity versus those who are advocating tax structures that help the rich or help, unrelated to their activities with respect to enhancing economic productivity.

So, I view a very strong part of the burden of the tax system as having to do with the design. Again, we can have bad design and good design and right now, I think we have been moving in the wrong direction.

Third, with respect to capital gains itself, a relatively small fraction of the capital gains comes from the picture of the innovative activity that you have in mind. Most of capital gains comes from real estate speculation.

I do not want to downgrade the importance of real estate as an important sector of the economy, but I think most of us think of, what is the strength of the new economy, the strength of the U.S. economy over the last decade? It has been innovation. It has been a whole set of activities like that and not building the kinds of empty office building that led to the real estate crash in 1988, 1989, or in the 1990's.

Most of the capital gains goes to the real estate sector, not to innovation. I am more sympathetic with special treatment for capital gains for innovation sectors than I am to real estate, but other people do not believe in that kind of differentiation.

I think it does make sense.

The final point I want to make is to reemphasize the point Bob made that the kind of financial engineering that one saw in Enron has been well known and can be used for—if you have special tax treatment of capital gains, can be used to avoid taxes.

I wrote a paper a number of years ago detailing how that could be done and how you could actually basically get rid of most of your capital gains.

Chairman SARBANES. It is probably in the Enron files.

[Laughter.]

Dr. STIGLITZ. Over the years, the tax authorities have tried to circumscribe one or the other of these kinds of devices and it explains a lot of the complexity of our tax code. And that complexity is part of the downside cost of our tax system.

Unfortunately, a lot of the creativity of our economy is going not into producing new products, but trying to circumvent the tax laws and finding out loopholes, on accounting and in this area. I think it is a mistake to try to provide them even more incentives to do that. And afterwards, if you want to find some advice on how to use our current tax system to avoid taxes, we can arrange for that.

Senator BENNETT. I am not talking about using the current tax system to avoid taxes. I understand that perfectly.

I do object to the canard that I hear over and over again that people will simply change their form of compensation to take advantage of the lower capital gains tax rate. And I hear that in the debate often.

Michael Jordan doesn't take shares in the Wizards. Michael Jordan takes cash. And if you say, we are going to give you shares in the Wizards so that you can get capital gains advantage when the price of the Wizards goes up and his knee goes out, he wishes he did not take shares in the Wizards.

You cannot transfer income from normal income, ordinary income, or earned income. To use the tax phrase, you cannot transfer from earned income to capital gains income without risk. It is not something that you just need a good accountant to do. Risk is always there and you are compensated for the risk. As Enron demonstrated, stocks go down just as much as they go up, and options become worthless just as often as they become valuable.

I was hired as the CEO of a company and was compensated in options. And I did such a wonderful job in the company that the options never ever exercised because the stock price never got as high as it was on the day I was hired.

Dr. STIGLITZ. Can I just say, much of the paper that I wrote was how you manipulate within the capital sector itself, borrowing money, moving within that, and avoiding. But it is also the case that there has been a lot of discussion, and I think some evidence, that firms—one of the reasons they use stock options is for the favorable treatment.

What a number of corporations are doing as the stock goes down of resetting the strike price, so implicitly, they are sharing the risk. They are absorbing the risk.

And if you look at the studies that have looked at overall compensation, what you see is that many executives do not bear the risk that you would appear to see that they would bear from the stock options because when things do not work out as well, there are other ways of giving them money, either through resetting the strike price or through other forms of compensation.

Chairman SARBANES. Does anyone else want to add anything before we move on?

Mr. MALPASS. I have a few points, if I may, Mr. Chairman.

Chairman SARBANES. Yes. Go right ahead.

Mr. MALPASS. In very rough terms, Federal revenues are $2 trillion per year and State and local governments add another roughly trillion dollars. So there is a lot of tax revenues.

Chairman SARBANES. Rates or revenues?

Mr. MALPASS. CBO, in its recent report, goes through some scenarios. Over the life of the budget, the 10 year life of the budget, even with last year's tax rate cut, they expect revenues from personal income taxes to rise from 12.8 percent of GDP now to 13.6 percent of GDP. And if we have a good economy, they will rise to 15.5 percent of GDP.

So even apart from the capital gains issue, we have the personal income tax as a burdensome tax. Also, the Social Security tax is a very burdensome tax on labor itself. It puts a wedge between the employer and what the employee really receives.

Now, as far as capital gains taxes, we should note that each time the rate is cut, the proceeds from capital gains are way above the projections.

We have a systematic bias in the way capital gains are perceived in the Government computer models. They don't fully account for, the fact that, when the rate is cut, there is more activity and more economic growth or simply transactions, and the total capital gains receipts get a good bump.

One of the debates last year that was very confusing to me was the assertion that if the capital gains tax rate had been cut, the stock market would fall.

I believe that economists would by and large agree that if you cut the tax on an exit from a given investment position, it adds to the value of that position.

I think it is demonstrable and almost a certainty that if you had a lower capital gains tax rate, you would see a big positive impact on the value of capital assets—stocks, bonds, and real estate. So that was a confusing debate to me on the sidelines last year.

A final point is the distribution of tax receipts from capital gains taxes, the issue of who actually pays capital gains. What I am struck by is that the rich actually can avoid much of the capital

gains tax by selectively taking gains. Also through the estate tax system and through the charitable contributions system.

I was just at a dinner the night before last with a big group of universities that receive a lot of charitable contributions. One of the sizable tasks that they have is taking care of rich people as they donate their appreciated property into the university before their death.

The rich person avoids capital gains taxation and gets higher current income from the charitable contribution. The whole process is driven by the heavy taxation of capital gains.

On the other side of it, the small business owner really doesn't have those mechanisms in order to avoid or work around the capital gains tax.

I think that the distribution of capital gains taxation falls very heavily on the middle class and entrepreneur, precisely the people that you would really rather leave the proceeds with.

Chairman SARBANES. Now as I understood Chairman Greenspan's response to this question that Senator Bennett put at the hearing last week, he made the observation that the capital gains tax revenues are factored into the numerator. But there is not an item that is factored into the denominator.

Therefore, the percentage of tax revenues compared with the gross product will, by virtue of that, be higher. And if you are getting more capital gains, the figure will look higher because you do not put any comparable item into the denominator. You get, in a sense, an overstated figure when you are trying to make these comparisons or something that certainly should be taken into account.

Of course, the point is that we have had a lot of capital gains in recent years with all of what has been going on in the market and that that had an impact on these percentages.

He was, I thought, very careful to try to make that point in the response.

Senator Reed.

COMMENTS OF SENATOR JACK REED

Senator REED. Thank you, Mr. Chairman. Thank you, gentlemen, for your testimony and your presence here today.

Dr. Stiglitz, you seem to have an urge to say something, and I do not want to deny that.

[Laughter.]

Dr. SOLOW. It is always the case, Senator.

[Laughter.]

Chairman SARBANES. What else is new?

[Laughter.]

Dr. STIGLITZ. Very briefly, let me just say that the Social Security tax, since the contributions that people make under the Social Security system are reflected in the benefits and move basically commensurate with the benefits, doesn't have the distortionary effect of other kinds of taxes. It is really like an investment. So viewing it that way I think is fundamentally misguided.

Second, it is the case that cutting capital gains taxes leads in the short run to increases in revenues because people worry that this is a temporary benefit and they want to take advantage while there is a sale going on.

The econometrics, the statistical evidence shows that over the long run, cutting the capital gains tax is like cutting any other tax—it leads in the long run to lower revenue and a worsening of the fiscal position of the United States.

I will stop at those two points. I have concerns about the other points, too, but let stop there.

Senator REED. Thank you, Dr. Stiglitz.

It seems to me that the proponents of tax cuts, and this in some respects seems to be the Administration's Swiss army knife for economic policy—it can do everything—base some of their judgments on a bet that productivity will increase at very prodigious rates for the indefinite future.

I wonder if Dr. Solow and everyone, if you might comment on your views on productivity increases.

Dr. SOLOW. Yes, I would be glad to. I should begin by saying that these quarter-to-quarter numbers that are reported are intrinsicly unreliable and volatile. Productivity has a numerator and a denominator. They can both change unpredictably. They can both change dramatically, and particularly when a denominator changes. It can change the value of the fraction very much. Quarter-to-quarter numbers are not an indicator of very much at all.

Over the longer run, in the quarter-century after the end of the Second World War, we had very rapid productivity increase, reflected directly in the rise in the standard of living of the country.

For mysterious reasons, for reasons which are not fully understood by anyone, the following 25 years, from about 1970 to about 1995, had extraordinarily low productivity increase. We thought, at first, that productivity was growing 1 percent a year. It turns out to be nearer a percent and a half a year after the data are revised.

Beginning in 1995, we had very rapid productivity increase again, and much of that is undoubtedly information technology related. A lot of it is related to other things, including organization innovations by businesses, and still other things.

It is very hard to extract from numbers like that what part is business-cycle-related—there is a normal pattern of productivity change in the business cycle—and what part is durable. What we really need to know is what is durable over the next 5 or 10 years.

I have put some time into studying that question in detail industry by industry, in fact, and so have many other people. I think a consensus is emerging that we probably have a durable benefit from accelerated technological change in the United States, especially in telecommunications and information technology, but that the period from 1995 to 2000 exaggerates considerably what we can hope for over the longer run.

The longer run forecasts, naturally uncertain, that make most sense to me are those that suggest that we can look ahead at something like 2 percent a year annual productivity increase, taking the private economy, the private business economy as a whole.

Two percent a year ain't hay. A number that rises at 2 percent a year doubles in about 35 years. So doubling the productivity of American workers in the course of a little over a generation is not a negligible thing. This is nothing like the 3, 3½, 4 percent increases that we saw during that 5 year period, which almost certainly cannot be repeated regularly.

The 2 percent a year is a little less than we got between 1950 and 1975, which were very good years for productivity. It is more easily explicable why we did so well in those years than why we did so poorly in the 25 years.

Senator REED. Thank you.

Dr. Stiglitz.

Dr. STIGLITZ. Just to add one thing. I agree with everything that he said. One point is that there has been a lot of research, a lot of thinking over the last 20 years of how you make decisions under uncertainty. These numbers are inherently uncertain. One of the principles is you do not spend money before you have it. And you revise policies as new information comes in.

So if you made a decision to spend a certain amount of money when you thought you had a surplus of $5 trillion, or whatever the number is, when it was a mistake to have spent as much as was spent, given the uncertainty. But when you have new information that comes in and that says it is much less than you thought, it calls for revising the policy decisions that were made under that framework.

Senator REED. Thank you, Dr. Stiglitz.

Dr. Krueger.

Dr. KRUEGER. I agree completely with what Joe and Bob said.

One point I would add is that one of the things that helps productivity growth and it has helped historically has been increases in education, increases in the human capital of the workforce. In the post-World War II period, we had very rapid increases in college attendance and high school graduation and so on. That source seems to have slowed down considerably.

So that is one of the reasons why I think it is very hard to predict going forward. The technological changes that Bob pointed to I think probably are durable, although the probably should be underscored, not the durable, in that sentence.

I also think there is a tremendous amount of uncertainty, even looking over the next 5 years, for what the productivity growth numbers will be. That is why the budget projections are so variable and often so far off. And given that reality, I think what Joe said is absolutely right, that one wants to adjust when one gets new information about what productivity growth looks like.

Senator REED. Mr. Malpass.

Mr. MALPASS. Senator Reed, very briefly, in my opening statement I went through the policy implications of this question. I think it is, indeed, worthy of a lot of thoughtful discussion. Could the productivity growth be as high as we have been recently witnessing? If it is anywhere close to that, as Dr. Solow says, even if it is 2 percent, that compounds rapidly.

From the monetary policy standpoint, it means that we may have a period where the inflationary impact of a given growth rate is a lot less than what we are used to. That means that the potential growth of the economy, or the possible growth of the economy, is higher than what we have thought in the past.

From the fiscal policy standpoint, it means that we may have surpluses rather than deficits. As I laid out in my statement, it is worthwhile for Congress to begin thinking about what we would do

if we really had a sizable surplus, to begin thinking about the glidepath.

Chairman Greenspan laid out a year or two ago the idea that if we run surpluses, if we have the higher productivity growth that we think we do, then the glidepath in the pay-down of the national debt will be uncomfortably rapid. He went through that in a rather detailed way.

Senator REED. But that was at the point that we had a projected surplus of several trillion dollars, which is much less now. It is not a glidepath. It is a cliff, I think.

Dr. STIGLITZ. Can I make one more remark which is a point that I had in my written testimony having to do with the short-run?

Whenever you have a recession, a down-turn, even a shortfall below potential, one of the impacts is that profits go down, and as his testimony pointed out, they have come down considerably in this economic down-turn. And when profits go down, firms cut back on their R&D. The cut-back in long-term R&D is even more in the short-term. Long-term R&D being focused on real productivity increases rather than just making sure that you can compete with the competitor.

I have been at some recent meetings with people who have been involved very strongly in the high-tech area. They say that there has been dramatic cut-backs in R&D in their firms and in their industry in the last year, last year and a half. And that portends very strongly for a slowing down of the pace of productivity over the medium-term, at least in that particular sector.

Senator REED. Well, you can correct me. My sense is that productivity is not at the levels that we saw in the late 1990's, at 2 percent. That, as a result, GDP will not grow as fast as it tended to grow. With the declining GDP and even a constant obligation by the Federal and State and local governments to spend money, the likelihood will be in deficit, not surplus. Is that your judgment?

Dr. SOLOW. It is not clear that we will be in deficit rather than surplus. But any surplus we generate will be much smaller than the very optimistic numbers that we had before.

You are quite right that with roughly 2 percent productivity growth and roughly 1 percent employment increase over the long run, the long-term growth rate for real GDP is likely to be of the order of magnitude of 3 percent, 3.1 percent, thereabouts. That is the number that I come up with. That is the number given in the Economic Report that the President issued a month ago. There is a fairly good consensus on that.

That is not, I think, going to generate large surpluses, nor is it going to give us much protection against inflation. Incomes tend to rise along with productivity. What was so fortunate about the period from 1995 to 2000 was that there was an unexpected splurge in productivity, and as a result, an awful lot of it was fed into cost reduction rather than into increases in earnings and other nonprofit forms of income.

I do not think that is likely to happen again. This works the other way, too. The double-digit inflation of the early 1970's that scared us so much came in part from the fact that wages and other incomes were rising as if productivity were to continue to go up as

fast as it did in the years after 1950. It did not, and prices went up instead.

Dr. STIGLITZ. Let me just make one more point, which is that the numbers that are often cited include the Social Security system. We should be putting away money for those obligations we have.

In addition, we have the long-term problem of Medicare. There are estimates of what is going to be happening to health care costs, that it will go up to 17 percent of GDP. And that is typically not fully accounted in the forecast.

So there is a real risk on that side, as well as on the GDP side that we have not really taken into account. I think it is irresponsible to spend the money before we have it and before we know what these expenditures are going to be.

Senator REED. Thank you very much. My time is expired.

Thank you, Mr. Chairman.

Chairman SARBANES. Senator Corzine.

COMMENTS OF SENATOR JON S. CORZINE

Senator CORZINE. Thank you, Mr. Chairman. I apologize to the witnesses for attending another hearing first. This is a remarkable panel and I intend to read all of your testimony.

Let me ask a question that relates to something that seems to come up on the floor in our debates fairly frequently with regard to tax policy. And that is the permanent repeat of the estate tax, which seems to get tacked onto every piece of legislation that gets presented to us that has any economic bearing. Would you all give some of your perspectives on its impact into the economy long-run capital formation? I hope this question has not been asked, Mr. Chairman.

I would start with Mr. Malpass and then work the other way, or vice-versa.

Mr. MALPASS. You put me on the spot first.

[Laughter.]

The one observation I would make on the estate tax is that it places huge costs on the economy. I think it is very hard to quantify those costs or be aware of how large they are.

I do not really want to go farther into exactly how it should be revised. But we should recognize the gigantic number of workers within the economy and systems within the economy that are devoted to dealing with the estate tax, from lawyers to accountants to the university systems, which have staffs and whole processes involved in helping people deal with the estate tax system.

We should be aware of those costs and also aware of the distortions that are brought on by the system that we have right now.

Dr. KRUEGER. My own view is that the estate tax is largely an issue of equity. Different people will have different views about what constitutes equitable taxation.

I think one issue that David raised which is important is the loopholes. What seems to upset people is having to spend money on lawyers to avoid the estate tax. I think they would probably be happier to give that money to the Government than to their attorneys. My own sense is that part of the outrage over the estate tax in the public has to do with the loopholes which they consider to be unfair.

I do think in terms of the economic impacts, there would be impacts in terms of charitable giving. I think from the standpoint of universities, for example, they will get fewer donations with the repeal of the estate tax.

Dr. STIGLITZ. Let me make a couple of points.

First, I think one has to think about the repeal of the estate tax in a broader context. In particular, in the context of the issue of the step-up of basis of capital gains tax, step-up basis for payment of the capital gains taxes. The step-up of basis, I believe that, as our previous discuss, we said that there should be a capital gains tax and that without that, there can be enormous tax evasion or avoidance—tax avoidance, I am sorry. And that without fully dealing with the problems of step-up of basis, repealing of estate tax is bad tax policy, both from efficiency and equity points of view.

The second point, a lot of the criticisms that have been raised against estate taxes have focused on small businesses, farms, and all those people who have to sell their property in order to pay the tax. I think there is a legitimate concern about that. But that could have been dealt with in a variety of ways other than the repeal.

For instance, giving people an extended period of repay, increasing the exemption level maybe to $5 million, but not the complete repeal. I think that was going far beyond what was necessary to deal with those problems.

I think there is very little evidence that the repeal will increase the efficiency. The core issue is the one that Alan pointed out, the issue of equity and what kind of society that we want to have.

There are going to be significant impacts on charitable giving. I think the evidence on that is fairly clear. One of the strengths of the American society and the American economy is based on the nonprofit sector. And I think that in some sense could be some of the most serious adverse effects of the repeal.

I do not think it is a bad thing that people are encouraged to give money to nonprofit organizations. But I have to admit that I have some self-interest in that particular perspective because I have been one of the beneficiaries of the nonprofit sector.

Mr. MALPASS. But the cost of that in the efficiency, or I wanted to ask your point on efficiency. Why don't we have to go through that, in the efficiency of extraction within the tax system?

Dr. STIGLITZ. I think the net cost of that is negligible compared to what happens more broadly in trying to evade a whole variety of taxes or to take advantage of special capital gains provisions, real estate provisions, and so forth. I think this is really second-order effect.

Dr. SOLOW. I think everything has been said here. I will take 30 second and emphasize a couple of points. There have been studies of the incentive effects on business entrepreneurs of the existence of the estate tax. And generally, they come up with very small numbers.

The key technical matter is constructive realization of capital gains at death. Under the present system, without the estate tax, there are large capital gains that escape taxation forever. And that cannot be appropriate as long as we are taxing capital gains elsewhere in the system.

This is primarily a matter of equity. There is no danger that well-off parents will be unable to create advantages for their children by educating them properly and endowing them one way or the other.

To return some portion of an estate at death to society or in anticipation of death to charitable organizations does not seem to me to be a bad thing at all. It seems to be a good thing.

The evidence is that, well, here we are, the most entrepreneurial society in the world. You would think that we had been stifling entrepreneurship for generations by having this tax. In fact, Route 128 and similar centers are crawling with businesses like that, somehow. People with the creativity to create enterprises will do it.

Chairman SARBANES. We will go around again, but let's move more quickly. We have four panelists and it takes a lot of time to get an answer. I am just going to ask a couple of questions and——

Dr. SOLOW. Five, counting Joe.

[Laughter.]

Chairman SARBANES. Maybe if I can get a yes or no or a short answer.

What is your view of the argument that the projections out that we would shift from a strong surplus position either to a weak surplus in the budget or even a deficit, because of the extensive tax cuts that were made, has had an impact in keeping up long-term interest rates? And that therefore, some of the stimulus that could have come to the economy by lower long-term rates was lost because we did this extensive tax cut and then people looked out into the future and they saw this.

So that was one way that the tax cut fed back into the current situation and, in effect, detracted from moving the economy forward. What is your view of that argument?

Dr. SOLOW. You wanted a yes or no answer. My answer is, yes, that has to be the case. Something in the capital markets has been lifting up expectation of interest rates in the future and it is at least in part the expected supply-demand balance for funds in the future. And that cannot help but be affected by the fiscal policy of the Government.

Dr. STIGLITZ. I agree. I have actually written that. One other factor is the uncertainty that all of us have been talking about gets reflected in the risk premium that is reflected in turn in the medium- to long-term interest rates.

And so, it is not just the average numbers we are talking about. It is the uncertainty by this commitment, seeming commitment we have made to a tax cut when we are not sure if we can afford it.

Dr. KRUEGER. I tend to share those views.

Mr. MALPASS. You asked four economists, so that often means six opinions. I will give you a different opinion.

It is pretty clear from the evidence that the fiscal deficit doesn't have much impact on bond yields. We have the experience from the 1980's. It is discussed in detail in my statement with a graph showing the bond yields versus the size of the fiscal deficit. As the expectations of the fiscal deficit and the actual fiscal deficit grew, bond yields actually came down heavily in the 1980's.

We have had the experience of last week. As it became clear that the U.S. fiscal deficit was going to be much smaller than people ex-

pected, or perhaps a surplus, yet bond yields are going up. The rise in yields is reflecting the expected growth of the economy, the inflation outlook, and I also think the currency outlook. Those are the dominant variables in a bond yield.

Chairman SARBANES. Now what about the argument that doing this extensive tax cut provided a stimulus to address the shortfall that we were experiencing here?

I take it this really goes to the question of whether, somehow, you can borrow frontwards or move frontwards tax cuts projected out into the future in order to provide a stimulus now. Does it work that way, or can it work that way?

Dr. SOLOW. I do not think it had or did. The Economic Growth and Tax Relief Reconciliation Act of 2001 was not passed in anticipation of a recession and it is not mainly an antirecessionary act.

I am sure that the early stages of that tax reduction did have the usual effect in supporting the demand for goods and services in the economy.

Chairman SARBANES. You mean the early stages, what happened in the current or the next fiscal year.

Dr. SOLOW. In the current fiscal year. But the notion that tax reductions scheduled for 5 or 6 years from now, or 4 or 5 years from now, can have a major effect on the current consumption expenditures of the population seems to me to be far-fetched.

Chairman SARBANES. Does anyone disagree with that?

Dr. STIGLITZ. No. The only other factor is the point made earlier that the anticipation of the worsening fiscal position has had a negative effect through interest rates.

Dr. KRUEGER. I was going to make the point also that rate cuts in the future should cause people to delay their labor supply today.

To the extent that there is some substitution in the way people work, it would work in the opposite direction, the future cuts. The rebates might have had some effect, I suspect. When the history of this period is written, it will probably be a small impact. But the future cuts, I suspect, were probably having no effect or a small negative effect.

Mr. MALPASS. People spend from their lifetime income expectations, the after-tax expectations of how much money they are going to have over their lifetime. So if the Government changes its view of how much taxes it is going to extract from people, that certainly has an effect on people's confidence about their near-term outlook.

If they see that their long-term after-tax income is going to be more, then that gives them confidence in what they are doing. I really think that it has to be the opposite of the points of view that we have just heard.

Dr. SOLOW. Even a believer in something like the permanent income theory of consumption, like me, for instance, understands that permanent income is discounted like other incomes and increments to anticipated permanent income 5 years down the line will not generate very large amounts of consumptions. I am perfectly at home and comfortable with that way of looking at consumption. But it cannot have any substantial quantitative impact, I think.

Dr. STIGLITZ. The work that I did in connection with the Nobel Prize emphasized the importance of credit rationing. And it is one of the reasons why you cannot borrow against income that you are

going to get in 5 years. The evidence in this particular episode is very strong that it has not had any effect.

Chairman SARBANES. Senator Bennett.

Senator BENNETT. Thank you.

I have to return to the estate tax for just a minute.

I agree with you, Dr. Stiglitz, that the stepped-up basis is a stupid idea. And it came because it was an attempt to ameliorate the impact of the death tax, which I think is another stupid idea. The problem with the death tax is that death is not a voluntary decision. It should not be an economic event. When I decide to sell a stock, I decide to sell a stock based on my analysis of my needs, the stock market, where things are. I make a rational decision, taking into account all factors. When my father dies, there is no such options. He dies because of uneconomic circumstances.

If his entire estate is cash, that is one thing. If his estate is a business, his death may occur at the worst possible economic moment for the survival of that business. But the Government pays no attention to that, assumes that it is cash, and demands payment within 9 months.

And so, in an effort to get around the arbitrariness of death, we get all of the battalion of lawyers, tax accountants, and others that you have talked about.

I have lived through a number of deaths. The most spectacular one from an economic point of view was Howard Hughes'. I was working for Howard Hughes when he died, and I watched the gyrations that everybody went through in an effort to preserve his assets, not necessarily for his heirs because none of his heirs expected to receive any of his assets. We spent a frantic amount of time trying to find a signed copy of the will that left everything to charity, which was Mr. Hughes' intention.

Mr. Hughes, being Mr. Hughes, never bothered to sign the will. And so, it did end up going to his relatives, none of whom expected a dime on his death.

I watched the gyrations that people went through to write down for assessment purposes the value of his assets, in many instances, to preserve those assets because they represented businesses that were not at that point in their lives where they could afford to liquidate into cash.

So, I would much prefer a circumstance that says, death is not a taxable event.

If Howard Hughes paid $10 for an asset, on his death, that basis stays unchanged. There is no step-up in basis. When the asset gets sold, no matter who sells it, it then produces a capital gain that is taxed at the existing capital gain tax rate, whether it is 20 percent or 28 percent or 25 percent or 15 percent, wherever it might be. And that means the people who own the asset can make an intelligent economic decision that the time has come to sell it and pay the tax, instead of an involuntary decision that says, uh oh, Mr. Hughes died 10 years before we expected him to. This business is not in shape to liquidate. But the Government said to come up with the money, as if it were cash.

Now comment on the economic impact of saying, okay, death is not going to be considered a taxable event. Therefore, there will be no stepped-up basis, and whoever gets the asset by virtue of some-

body's death is facing a capital gains tax on the original basis, just as the individual would have faced it if he had survived.

That, by the way, is exactly what would happen if the asset were given to a corporation at the very beginning when the corporation decides to sell it, and the corporation can live for 150 years before it decides to sell it. It pays the capital gains on the original basis.

Chairman SARBANES. I am going to have to excuse myself because of another engagement for which I am now quite far behind. Senator Corzine will take over and conclude the hearing. But I did not want to leave without thanking the panel for your contribution. We really very much appreciate it. And I have looked through the statements and obviously, a good deal of work went into these statements as well.

This has been a fascinating session. It could go on indefinitely. And I apologize to Senator Bennett.

Thank you all very much.

Dr. SOLOW. Since I am closer to this taxable event than any of my colleagues——

[Laughter.]

—I will take the first crack at it. If it is good public policy that unrealized gains on capital assets should escape taxation for time periods measured in generations, in five, six, seven, eight generations, then I might agree with the direction of Senator Bennett's comments. I do agree with him to the extent that I think it is a little odd that death should be such an important taxable event.

I would think that a reasonable way of dealing with that, to say that, at the very least, death is a transaction or the passing on of assets at death is a transaction. And there is something very peculiar about different treatment of someone who sells an asset 10 minutes before he or she dies and someone who forgets to do that and holds the assets for 10 minutes more.

It would be my choice in view of the equity considerations and the kind of society that I at least like to think of us as having, I could be happy if the transfer of an asset at death, which is, after all, from one person to another person, were treated as a transaction and what in the modern vocabulary is stepping up the basis, or what I learned to call constructive realization of capital gains took place. Then assets would be treated as if death constituted a sale to heirs. By the way, not all of those heirs have to be members of the family. They can be others.

Senator BENNETT. But it is an involuntary transaction.

Dr. SOLOW. No, it is not an involuntary transaction. That transaction could have taken place earlier, had anyone wanted to make it, and might have taken place if the tax laws were different. And not to sell something is as much a voluntary action as to sell it.

Dr. STIGLITZ. Let me just make a couple of points.

First, I think that smart businesses tend to buy insurance that can pay the capital gains taxes—the estate taxes. So, we have a vibrant insurance industry, so the issue for most individuals can be covered.

Senator BENNETT. You are assuming that the cost of insurance is a minor issue to the business. There is a cost.

Dr. STIGLITZ. There is a cost.

Senator BENNETT. There is no cost-free way out of this.

Dr. STIGLITZ. But you have to understand, it is also the case that in a competitive market, with the tax preferences associated with the insurance industry, on average, it is not really a cost.

I really do think that the stepped-up basis is very distortionary. It is also the case, though, that not forcing a constructive realization in one form or another leads to this problem that is well documented, called the locked-in effect, that it discourages the turnover of assets. And it is very important to address that issue.

I think that there are a number of ways in which one can try to facilitate, help people who are facing the kinds of situations that you describe.

I think that, for instance, under current law, they can, I believe, have, if they are small businesses, extend the payments over a number of years. I could imagine extending that more generally with an interest charge that reflects the cost of the deferred receipt of the Government. I do not think that is unreasonable.

Finally, in the end, I do think that, as I look at it from the point of view of the efficiency effects, not talking about the equity. I would make a trade-off in which I would have a step-up of basis, constructive realization and a somewhat lowering of the estate tax from what it was, but clearly not the elimination of the estate tax.

Senator BENNETT. We could debate this, but my time is gone.

Just one last thing. Dr. Solow, if Howard Hughes had decided to put his initial stock in a corporation rather than in his own name, it would have stayed in that corporation for generation after generation after generation and you wouldn't object to that because it wasn't an individual. And the people who ran the corporation would decide when to dispose of those assets and they wouldn't have had the cost of any insurance firm to do it. They would make intelligent business decisions on the disposition of the assets and they would pay the capital gains tax when it came. You are treating individuals different than corporations.

Dr. SOLOW. I would regard that as a loophole and if I were a legislator, I would consider closing that loophole.

Senator CORZINE. Okay. Let me change subjects here.

Mr. Malpass, being an old washed-up bond trader, I thought you picked the timeframes for increases in debt associated with the rise in interest rates at a rather interesting time. You picked the 1980's and you apparently were picking 1982 or 1983, when we were at the peak of interest rates and debts had continued to go on.

If you had just turned the clock back 6 years, I think we were at very low rates, roughly where we are now, 5½, 6 percent on long-term rates. And the expectations of growing deficits took us to 13 or 14 percent, if my memory serves me correctly, about 1982 or 1983, and a clear sense at least of when I was sitting at the desk buying and selling bonds, that supply had something to do with the level of anticipated interest rates.

I think that those levels stayed very high throughout the 1980's. There were some dips as people thought we were going into recessions or had different problems. But I do not see that correlation that you pointed out.

Then I wonder about the analysis even under the circumstances that we see a little stronger economy. No one is revising down dramatically the kinds of changes in borrowing arrangements that we

are going to have over the next decade and certainly not as they look out beyond the ending of this tax cut and the demands that we are going to have with regard to Social Security and Medicare and Medicaid.

I actually draw almost the opposite conclusion with regard to my own personal experience of looking at the correlation of anticipated debt financing relative to interest rates. It is not a one-to-one correlation. But I would have a hard time explaining what happened in the late 1970's and in the early 1980's with regard to the expansion of debt.

I do not know whether you want to comment.

Mr. MALPASS. Well, there was a huge change in the value of the dollar in the 1970's. I think what was going on in the 1970's was a mis-estimate by the bond market of the amount of inflation that was coming out. And so, the yields stayed low. I imagine that people lost a lot of money being long bonds in the 1970's because there ensued a very high inflation rate, not because of the fiscal deficit, but because of the change in the value of the dollar and the inflation that came out of it.

As I look at the graph of the 1980's, it looks to me that as the fiscal deficit went bigger and bigger and bigger, you had a steady decline in the 10 year bond yield falling from 10 percent in 1981 all the way down to 7 percent by the late 1980's. And then we have the reverse process, of course, in the 1990's, as we moved toward fiscal surplus. We actually ended up with an 8 percent interest rate in 10 year bond yields in the year 2000. Even as we had moved into a solid fiscal surplus, the bond yields were actually going up. I think that was related to the growth rate that we had going at that time.

Dr. STIGLITZ. Can I say something?

Senator CORZINE. It certainly did not stay there very long, though. It came crashing back down to lower levels when people thought they were going to be sustainable pay-downs in debt.

Mr. MALPASS. It is hard to find the fiscal correlation. We were moving into a recession and we moved toward rate cuts by the Federal Reserve.

Senator CORZINE. Dr. Stiglitz.

Dr. STIGLITZ. The general point that I think you raised is that interest rates reflect demand and supply for bonds. That is basic economics. That demand and supply are affected by a number of variables. In economics, we call it multivariant analysis. We do regressions. Looking at one variable is likely to be misleading.

The appropriate question is, given everything else, what is the impact of increased deficits? And viewed that way, I think it is unambiguously the case that increased deficits mean that the Government is going to have to borrow more. Reduced surpluses means that the Government is not buying back as many bonds as it otherwise would, the same basic story.

When that happens, the interest rates, those will be reflected in the interest rates relative to what would have happened in the absence of that action? Lots of other things are going on in the world. We cannot control them all. But that clearly is the dominant factor.

Senator CORZINE. There are studies out that show those correlations, I take it.

Dr. STIGLITZ. Yes.

Senator CORZINE. We probably should cite those for the record at some point and try to get them in because I think this is one of those debates. It is like the estate tax that we have on a daily basis around here.

It would be great to have some objective evidence.

I appreciate it. This is the first time I got to chair a hearing and I will close it.

Thank you.

Dr. STIGLITZ. Thank you.

Dr. SOLOW. Thank you.

Mr. MALPASS. Thank you, Mr. Chairman.

Dr. KRUEGER. Thank you.

Senator CORZINE. This hearing is adjourned.

[Whereupon, at 12:55 p.m., the hearing was concluded.]

[Prepared statements supplied for the record follow:]

PREPARED STATEMENT OF ROBERT M. SOLOW

NOBEL LAUREATE IN ECONOMICS, 1987

PROFESSOR OF ECONOMICS, MASSACHUSETTS INSTITUTE OF TECHNOLOGY

MARCH 12, 2002

I want to thank the Committee for the opportunity to testify today on the economic outlook. This initial statement will be short and pointed, because I believe that a lively discussion will get us closer to where you want to go.

The current economic situation is a living example of the reason why most economists think of monetary policy as the tool of choice for short-run economic stabilization purposes. We have been told by the National Bureau of Economic Research that a recession began exactly a year ago. The Council of Economic Advisers, in its *Annual Report,* seems to think that the recession began on September 12. But then, to everyone's surprise, including mine, the first revision of data for the fourth quarter of 2001 showed that real aggregate output actually rose nontrivially, and gained back everything it had lost in the third quarter. The preliminary tea leaves suggest that the current quarter will show a further gain in real GDP, probably faster than the quarter before.

So with maybe only one down quarter, was it worth calling this a recession? Perhaps more to the point: Is that really the right question to ask? I think the answer is No, and focusing on that questions leads to unnecessary confusion. There are some good reasons to fear that the current upswing will be weak, at least for a while. Corporate profits and business fixed investment are still falling. Unemployment will continue to rise for a while. Much of the strength in the fourth quarter came from consumption spending, but more than half of that was on automobiles, and thus very likely borrowed from later quarters, enticed by temporary incentives. Europe and Japan have been stagnant or worse, and do not seem to be turning around as rapidly as the United States. They will not be good markets for American producers; on the contrary, they will be trying very hard to sell in the United States. All in all, I was going to conclude that only God knows how the next few quarters will turn out; but it may be that God has not yet decided.

In this kind of environment, it is hard to know what to do now. The Federal Reserve doesn't know any better than you or we do. The fundamental difference is that the Fed can act quickly and then, if it soon changes its mind, it can reverse itself quickly. It would be helpful if fiscal policy could be mobilized in tandem with monetary policy, but you can not reverse yourself.

This lack of maneuverability in fiscal policy explains why the so-called "automatic stabilizers" are so valuable; they do adapt to events, without requiring you, or anyone, to take action. But they have been allowed to get weaker, for various special reasons. They are not likely to be revitalized. Maybe it would be useful if you could enact a "standard stimulus package" (which, worked in the other direction, could serve as a standard cooling-off package). It could be triggered automatically by events—at one of several levels—or even proposed by the President, and subject to a straight up-or-down vote. I realize that no such thing is likely to happen; maybe you have a better idea.

There should be a more appropriate basis for making stabilization decisions than wondering if there is or is not a recession, and when it will end. In fact, I think it would still be a good idea to pass a stimulus package in spite of the current lack of clarity about which way the economy is headed. I will explain why, briefly, because that may help untangle fiscal policy from the inevitable uncertainties of forecasting that Congress is too ponderous to deal with, unlike the Fed.

Real GDP in the fourth quarter of 2001 was only about 1 percent higher than it was in the second quarter of 2000 when the clearly visible slowdown began. Two years ago the unemployment rate was about 4 percent, compared with 5.8 percent now. Capacity utilization in industry was then measured at 83–84 percent, compared with 74–75 percent now. Suppose that early 2000 was a desirable state of the national economy. (Some thought it was a little too prosperous for peace of mind about inflation; but that requires only a small change in what I am about to say.)

We have to presume that the economy's aggregative productive potential has been increasing fairly smoothly since then, because that is how it usually behaves. The Council of Economic Advisers estimates that the rate of increase of productive potential is a hair over 3 percent a year. In that case, full utilization of our economy's potential this spring would entail a real GDP about 6 percent higher than current output. By this time next year, even if the economy grows by 3 percent this year (which is slightly faster than the Council's forecast in the *Economic Report*), there will still be a 6 percent gap of unused economic potential. The gap will be larger if the economy grows more slowly, and smaller in the opposite case.

That gap cannot be safely closed in a single year. The Fed would certainly fear that an upswing fast enough to do that is fast enough to exceed the inflation-safe speed limit, and would choke it off. But it would certainly be safe to grow fast enough to close some of that gap. That is why I think there is still room for a modest stimulus package, if you are capable of enacting a sensible one. By sensible I mean effective, temporary, and free of partisan sacred cows. The House bill started off as a ghastly mockery. And it has gotten better, just not enough better to be acceptable. Accelerated depreciation is not the best way to promote capital spending, and it fails the test of being temporary.

I mention all this for a broader reason. All this talk about whether there is or is not a recession, when did it begin and when will it end, leads to confusion because nobody knows. Anyway, it concentrates on the wrong thing. The CEA can make approximate calculations of economic potential; in effect it already does so. The Congressional Budget Office does something similar. Focusing on that would force debate on the right issue, which is where we stand relative to potential, and would provide a better guide to policy.

I should say that I am one of those who thinks the Economic Growth and Tax Reduction Reconciliation Act of 2001 was a big mistake. Part of the "surplus" it gave away has already evaporated, as we knew it would as soon as the economy weakened. And we have converted the rest mostly into future consumption instead of the future saving and investment that the country urgently needs as it looks ahead to an aging population. You should resist any suggestion that stimulus should take the form of advancing the date at which an ill-advised decision comes into effect.

Like most observers, I think that monetary policy has done very well in coping with the past five quarters. Long-term interest rates have not fallen very much. Nevertheless, if the Fed had behaved more traditionally the housing sector would not have held up as well as it has, the auto industry would have had a harder time providing those successful incentives, and business investment might have fallen even faster.

Some people complain that the Fed stuck with its contractionary stance a bit too long in 2000. Maybe it did; hindsight is usually 20–20. But perfection is the wrong benchmark against which to judge Alan Greenspan and the Federal Open Market Committee. They are not omniscient; I have already said that they are, like the rest of us, uncertain about what will happen next month. What distinguishes the Fed is the flexibility with which it handled the boom of the late 1990's. If you want to see how well they have performed, take a look at the record of the much more doctrinaire central banks of Japan, the U.K., and Europe.

What we have a right to hope for is that the Fed will exercise the same kind of informed flexibility in the course of the coming upswing, whatever shape it takes. If the recovery is indeed anemic, then the gap between current and potential output, which is already ample, will be widening; there will be no need to move short-term interest rates higher. Anecdote is piling up that lenders are being extra-cautious, as a reaction to the Enron swindle. Suspicion falls especially on smaller, less well-known companies without much of a track record, and they find it hard to get credit. Other things equal, this state of affairs should incline the Fed toward maintaining liquidity and credit ease. (It is this kind of circumstance that makes me suspicious of even a reasonable formula like the so-called Taylor rule: Why should the central bank ignore this kind of market fact?) But if the economy picks up enough speed, the margin of slack will narrow. In that case, we have to expect the Fed to begin positioning itself for the inevitable palaver about soft and hard landings, and interest rates will rise pretty quickly. Having a flexible monetary policy means learning to live with a certain number of tentative and even reversible steps. Right now I imagine wait-and-see is the right attitude.

All of the above was written before I saw Alan Greenspan's statement to this Committee last week. It contained no surprises, unless you count his strengthened conviction that the third quarter of last year would be the only down quarter. At this late date, I would not count it as a surprise.

There is only one point I would like to call to your attention. Mr. Greenspan agrees that the upswing now launched is likely to be "subdued," and he gives the standard reasons for suspecting a slow increase. He waffles a bit, but a little of waffle is justifiable. He reports that the FOMC forecast is for real output to increase by 2.5 to 3 percent during the four quarters of 2002. That forecast is 6 weeks old, and thus possibly already out of date. Anyway this pace is just a bit slower than the estimate I quoted from the *Economic Report* that potential output is growing at about 3.1 percent a year. The last decimal place in such estimates is not to be taken as doctrine, of course. The underlying point is that in this scheme of things, the gap between actual and potential output will not narrow during the rest of this year. That is what matters, not just whether the movement is up or down. The

implication is that a somewhat faster path for the economy would be desirable; a slower path definitely would not.

PREPARED STATEMENT OF JOSEPH E. STIGLITZ

NOBEL LAUREATE IN ECONOMICS, 2001
PROFESSOR OF ECONOMICS AND FINANCE, COLUMBIA UNIVERSITY

MARCH 12, 2002

It is a pleasure to appear before you to provide my assessment of the outlook for U.S. economic growth and employment and the appropriate public policies to promote those objectives. I will divide my remarks into seven sections. In the first, I will discuss the overall prospects for the short and medium term. In the remaining sections, I shall address specific policy concerns.

The Overall Prospects

While economists always look into the future with cloudy crystal balls, they are particularly cloudy when it comes to forecasting turning points. The question that is repeatedly asked is, is the recession over? I think, however, that that is the wrong question. There is little doubt that for the past year, the economy has been performing substantially below its potential. The potential growth rate of the economy clearly improved through the 1990's, and even if the robust growth of the late 1990's could not be sustained, there is a widespread consensus that the economy has a potential for growth of between 3 to 4 percent. Taking the mid-point in that range of 3.5 percent, even a positive growth of .5 percent would represent a shortfall of $300 billion in our 10 trillion economy—an enormous wastage of resources, even if we were to ignore the tribulations imposed on those forced into unemployment. Moreover, we should remember that America's unemployment insurance program is one of the poorest in the advanced industrial countries. It is unconscionable that benefits be terminated after 26 weeks. The argument that providing extended benefits would attenuate search incentives is nonsense: The problem is a lack of jobs, not the lack of job seeking. I shall return to this later.

While a great deal of pleasure is being taken in the fact that the rate of job destruction has been reduced, our economy needs to create a couple hundred thousand jobs a month to just break even, to ensure that employment keeps pace with the growing labor force. It is not a mark of success if the *unemployment rate* comes down because workers have become discouraged from working, so the number of job seekers is reduced.

Broadly, there are three types of recessions—those associated with inventory cycles, overinvestment in capital and housing, and financial crises. The current downturn is a combination of the first two. Some of the downturn was associated with a decrease in the stock of inventories. There were reasons to believe that with the New Economy, inventory cycles would be attenuated and become less important as a source of economic volatility, as better control mechanisms kept inventories better in control, as production methods (just in time production) reduced the required size of inventories, and as the overall size of manufacturing in the economy declined. As the economy nears the end of the period of inventory retrenchment, this source of negative drag on the growth of the economy will be eliminated. This, by itself, would suffice to bring an end to the recession; but it will not be enough to restore the economy to robust growth.

The overinvestment in certain key sectors of the economy has left an overhang, which will take some time to redress fully. The good news is that some of these areas are those in which technological advances have been proceeding at a rapid pace, so that much of the old IT equipment will become obsolete relatively quickly, before the equipment wears out, and this will help restore demand for new IT.

There are a number of other negative forces which suggest that the economy will continue to operate substantially below its potential, and which represent a substantial risk for a strong recovery.

Consumer Spending

Robust consumer spending has sustained the economy. The U.S. savings rate remains dismally low, which is not good for the long-run prospects for growth. Part of the explanation for the sustained spending is the mortgage refinancing which resulted from the lowering of interest rates, part from the special deals that automobile dealers were offering. Given that consumption has not fallen in the way that it does in a typical downturn, it is unlikely that an increase in consumption will provide a strong impetus for growth in the short run. Moreover, there are several

reasons to believe that the forces which have sustained consumption could weaken. (i) Mortgage rates may well rise; as it is, they have fallen far less than the short-term interest rates have fallen, partly for reasons that I will discuss later. (ii) Similarly, it is not obvious that the special deals on automobiles will continue. (iii) The heavy indebtedness of the consumer may impose an important dampener on spending, one which will become especially important if interest rates rise. As it is, by some estimates, consumers are spending 14 percent of their income on debt service. (iv) If the unemployment rate is not soon brought down significantly, fears of job security may increase, and given the poor unemployment insurance system, workers may be induced to save as a precautionary measure. (v) One of the primary reasons for the low savings rate is that through the nineties, households saw their wealth increase through capital gains, even without putting aside money out of disposable income. But with stock prices down or increasing slowly, it will gradually dawn on consumers that their wealth is less than it once was, or than they thought. The switch to defined contribution pension systems may exacerbate the resulting instability. Today, individuals must bear the risk of stock market fluctuations.

Capital Spending

Long-term interest rates have not come down anywhere near as much as short-term interest rates. One of the reasons for this may be the increasing uncertainty about the country's long-term fiscal position, caused in part by the large tax cut, where we seemed to be spending money before we got it. In addition, there is continuing worry about problems of valuation in the corporate sector. I served on the SEC Commission on Valuation, which focused on the difficulties of valuation in the new economy. While there was general recognition that old accounting principles might be ill-suited for providing accurate pictures of the economic prospects of firms, many on the Commission believed that the market should be relied upon. Enron and Global Crossing confirmed the suspicions of the skeptics, and today, many if not most investors feel high levels of uncertainty about the numbers that many corporations are reporting. This may dampen stock market prices, at least for a while.

Exports

The strong dollar and the weak international situation suggests prospects for exports remain diminished.

Technology

A source of some concern is that the economic downturn has led many firms to decrease significantly their investments in R&D. And investments in long-term research—the kind that is likely to result in productivity increases down the line—has been particularly hard hit, in ways that are hard to assess from the numbers alone. This is likely to be one of the lingering costs of not having responded to the economic downturn earlier, with stronger measures. (I do not include the House or Administration so-called stimulus package among the stronger measures that would have made a big difference.)

The one positive (from a macroeconomic perspective) is the increased military expenditure; but such expenditures detract from resources that could be used to increase long-term productivity, and hence to not contribute to the long-term strength of the U.S. economy.

It will be noted that I have not listed the tax cut as a major positive factor. Its net impact on the economy is in fact ambiguous. It was not designed to stimulate the economy, and its regressive features and other elements of its design suggest that the bang for the buck is likely to be quite low. On the other hand, the quickly diminishing surplus (and, in some years, the emerging deficit) that resulted lead to upward pressures on interest rates. The Fed only controls the short-term interest rates. What firms care about far more is the longer-term interest rates that they have to face, and the tax cut has changed the yield structure adversely, and in ways which are quite dramatic: There has been an almost 4 percent reduction in short-term interest rates, with less than a 25 basis reduction in some long-term interest rates. And while this weakens the prospects for a robust short-term recovery, its implications for the longer term are even more bleak.

Tax Cut

This brings me naturally to the subject of the tax cut. The tax cut was not only ill-designed for stimulating the economy in the short run; it was also badly designed for promoting long-term economic growth. (I put aside for the moment broader concerns about equity.) There are tax reforms, for instance, that would have done far more to promote investment in the short run with far lower budgetary costs, like the net investment tax credit and better income averaging provisions. I strongly side with those who believe that when one makes a mistake, one should recognize it. It

is not just the size of the tax cut that was a mistake, but its design. Given the peculiar structure of the tax bill—with provisions which expire in 10 years—it is inevitable that the issues will have to be revisited. It is better that that be done sooner rather than later.

Foreign Economic Policy

One of the sources of strength of the U.S. economy during the 1990's was increased exports to emerging markets. This was partly a result of trade opening, partly a result of the robust economy in those regions. Mismanagement of international economic policy by the IMF has contributed significantly to a worsening of prospects. Much of Latin America today faces stagnation, recession, or depression. As people in these countries look at the performance of their economies over the so-called reform decade, they see growth rates that are half those that prevailed in the much criticized pre-reform period (the so-called import substitution era), though, to be sure, better than during the lost decade of the 1980's. There is a growing disillusionment with the IMF, and with the United States, which is seen as responsible for its policies. While there was consensus in the United States that in the face of an economic downturn, there should be a fiscal stimulus—the debate was only over how to design the most effective stimulus—the IMF was seen as pushing for contractionary policies. The question is being asked everywhere, why? The asymmetries associated with trade liberalization of the past have increasingly come to be a source of resentment, and recent actions in steel have only heightened a perception of hypocrisy. The European initiative of unilaterally eliminating trade barriers for the poorest countries ("Everything but arms") is one of the few positive developments, but the United States, by failing to take corresponding actions, is increasingly losing standing. Unless the United States does something, both to ensure that the IMF pursues policies which are more in accord with the economic well-being of the developing countries, and especially the poor in those countries, and to ensure that there are movements toward a more balanced trade agenda, it is hard to see a renewal of the kind of growth in exports to these countries that has played such an important role in our own country's growth in the future. (There are even more important consequences for global economic and political stability.)

We won World War II, but we also won the Peace that followed. The Marshall Plan was not only magnanimous, but it also won lasting allies in the struggle for peace and democracy. We stand on the threshold of winning the War against terrorism, but will we win the Peace? Though the link between terrorism and poverty is complicated, this much is clear: Unemployment and poverty, especially among young males, provide fertile feeding grounds. The United States has neither provided aid nor trade; among the major more advanced developed countries, it is the stingiest in providing assistance to the less developed. The contention that aid does not work is simply wrong, and those who assert this must neither have looked at the evidence nor gone into the field. I have seen aid work: Small irrigation projects that double or triple the incomes of desperately poor, education projects that have brought literacy and meaning to those who otherwise would not have had it, health projects eradicate river blindness and other diseases that have plagued some of the poorest countries of the world. Statistical studies at the World Bank have shown that aid, when appropriately directly, has significant effects in increasing growth and reducing poverty. To be sure, not every dollar of aid is well spent, but the same thing could be said for any other category of expenditures, whether in the public or the private sector. The Monterey meeting in Mexico on finance for development is an occasion on which we could make a commitment both to increased assistance and to explore innovative ways of helping the developing countries more. It is our moral duty; it is also in our self-interest.

The continuing large trade deficit of the United States represents a potential source of instability, not only for the United States, but also for the world. If an objective outsider were to conduct the kind of review of the U.S. economy that is regularly conducted for other countries around the world, the grades would be mixed: The abysmally low savings rate, the high trade deficit, the worsening fiscal situation. The problems are all related, and the prospects are that some could even get worse in the short run. The reason that we have a large trade deficit, as I noted, in part is due to the strong dollar. As in the early 1980's, a large tax cut has led to a massive worsening of the fiscal situation. The trade deficit is simply the difference between what we invest and what we save. National savings (including public savings) has gone down from what it otherwise would have been. The trade deficit would have been even worse, were it not that investment too has gone down. But when our economy recovers, investment will increase, and with it there is a good chance that the trade deficit will worsen. We should be clear: It is not protectionist policies abroad or unfair trade practices that have caused our problems,

whether they get reflected in the steel industry, the automobile industry, or elsewhere; it is our overall macroeconomic framework I suspect the full adverse affects of the tax cut are yet to be felt.

Addressing the Sources of Our Current Problem

If we are to formulate policies aimed at enhancing the strength of the economy in the middle to long run, we must understand better the sources of our current downturn, of the massive underperformance of the U.S. economy. While every boom comes to an end, there are lessons to each. Earlier booms and the busts that followed taught us the dangers of inflation, and of the Fed stepping too hard on the brakes to stop inflation. We have learned the dangers of excessive inflation; and inflation was not the cause of the current downturn. The recession of 1991 can ultimately be traced back to weaknesses in the financial sector, those in turn in part to the excessive deregulation of the 1980's. I am not sure that we have learned those lessons, or the lessons of the excessive exuberance of the late 1990's.

In some ways, it is a familiar pattern: Deregulation in a sector (here telecommunications) leading to excessive investment in that sector—in this case the problems exacerbated by breathtaking technological developments and deregulation in the financial sector. The Glass–Steagall Act was concerned with the problems raised by conflicts of interest. It was foolhardy to think that such behavior would not reappear with its repeal.

At the time I served on the Council of Economic Advisers, we raised strong concerns about conflicts of interest and problems in accounting standards and practices, particularly as they related to derivatives and options. Our concerns have proved to be on the mark. There were others who raised similar concerns. Arthur Levitt, of course, was right in calling attention to the conflicts of interest in the accounting firms, when they simultaneously provide consulting services. FASB called for a changing of accounting practices to more accurately reflect the costs of options given to executives. And I strongly agreed. The Secretary of the Treasury and the Secretary of Commerce, however, violated basic principles of good governance, which call for the independence of FASB, and intervened to squash the proposed revisions. They succeeded.

I have devoted much of my academic life to the economics of information, and to the consequences of imperfections of information. The proposed revisions would have improved the quality of information. To be sure, some firms' economic prospects might have looked worse as a result, and its stock market price might have fallen as a result—as well it should. It was inevitable that a day of reckoning would come. Providing misleading information only delayed the day of reckoning, but worse, it led to a misallocation of resources, as overinflated stock prices led to the excessive investment which is at the root of the economic downturn.

Some contend that it is difficult to obtain an accurate measure of the value of the options. But this much is clear: Zero, the implicit value assigned under current arrangements, is clearly wrong. And leaving it to footnotes, to be sorted out by investors, is not an adequate response, as the Enron case has brought home so clearly. At the Council of Economic Advisers, we devised a formula that represented a far more accurate lower bound estimate of the value of the options than zero. Moreover, many firms use formulae for their own purposes, in valuing stock options (charging them against particular divisions of the firm). However, Treasury, in its opposition to the FASB concerns, was singularly uninterested in these alternatives. I leave it to others to hypothesize why that might have been the case.

If we are to have a stock market in which investors are to have confidence, if we are to have stock markets which avoids the kind of massive misallocation of resources that result when information provided does not accurately report the true condition of firms, we must have accounting and regulatory frameworks that address these issues. As derivatives and other techniques of financial engineering become more common, these problems too will become more pervasive. While headlines and journalistic accounts describe some of the inequities—those who have seen their pensions disappear as corporate executives have stashed away millions for themselves—what is also at stake is the long run well-being of our economy. The problems of Enron and Global Crossing are part and parcel of the current downturn.

Energy Policy

There is a widespread agreement among economists that GDP does not provide a good measure of economic well-being. We should, at the very least, take account of the degradation of the environment and natural resources. Bad information systems can lead to bad decisionmaking (as we have seen recently in the corporate world.) Nowhere is this more true than in energy policy. Extraction of oil and natural gases may increase our *measured* GDP, but it does not increase our economic

well-being commensurately. We should take account of the depletion of our resource basis, and the degradation of our environment as a result of carbon emissions. An energy policy which focuses on "drain America first" is not even good for long-run national security, for it leaves us potentially more vulnerable in the future. Long run economic growth (correctly measured) and long-run political strength both suggest that we should focus more on conservation. And basic principles of economics suggest that what is required is incentives, carrots and sticks. Why should we think that moral suasion would be more effective in this arena than it is in any other area of economic activity?

Social Security

I want to conclude with a few remarks about one of our long-term problems, our Social Security program. Our Social Security program has been an enormous success. We have brought the elderly out of poverty, and we have provided a new measure of economic security to the aged. Transactions costs are low. Improvements in the design of the program over the years have reduced some of the unintended inequities, reduced any adverse effects it might have on labor supply, and increased overall efficiency. There is still a way to go to put it on sound financial grounds.

Economics is traditionally described as the science of choice. The legacy of the Clinton years, a huge fiscal surplus, provided us with an opportunity to make some choices. We could have used some of these funds to put the Social Security system on sound financial grounds. We could have fully funded the system, and we could have then decided on how to proceed in the future. We have largely squandered that opportunity. Proposals for partial privatization typically leave the fiscal situation of our Social Security worse off. They do not provide additional funds to fill in the gap; some proposals simple force current and future beneficiaries to take a cut in benefits. Any reform proposal which does not begin by addressing the question of how current unfunded liabilities are to be financed is irresponsible, and should be a nonstarter.

Elsewhere, with Peter Orszag, I have described at greater length 10 myths concerning Social Security that have been widely circulated. One that has recently received considerable attention is the low return on Social Security accounts. We should be clear: Social Security funds are invested well, but conservatively. To the extent that capital markets work efficiently, then any higher returns that might be received would simply reflect the higher risk. It is imprudent for those approaching retirement to invest all, or even most, of their assets in high-risk investments. If there were a decision to undertake greater risk, the public Social Security system could do so, again at low transaction costs. (The transaction costs in the privatized part of the British system have been estimated to reduce benefits by 40 percent from what they otherwise would have been!)

Part of the reason that in partial pay-as-you go Social Security systems, it appears that returns are low is that some of the returns are used to bear the costs of the unfunded liabilities. The problem of funding those unfunded liabilities does not go away with partial or complete privatization. It will have to be borne elsewhere. To assess the merits of any reform proposal, therefore, one must know how, and who, will bear these costs. To do otherwise is dishonest. It may put in jeopardy the long-run prospects of our economy, for a day of reckoning will come.

Concluding Remarks

I continue to believe that the basic fundamentals of the U.S. economy remain strong. But I have seen the fortunes of countries change quickly, as a result of economic mismanagement. The decisions, the choices, we make today will affect not only economic performance during the next year, but also our long-run prospects. I believe that the tax cut that was enacted last spring was based on a serious miscalculation of our economic situation. It is a decision which, however, is reversible. If we do not revisit the issue, in the light of the new information which has come to light and the new situation which has evolved, the damage which could be done may itself be irreversible—or at least it will take a long time to undo. It will take political courage. Much is at stake.

PREPARED STATEMENT OF ALAN B. KRUEGER

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PROFESSOR OF ECONOMICS, PRINCETON UNIVERSITY

MARCH 12, 2002

Good morning, Mr. Chairman and distinguished Members of the Senate Banking, Housing, and Urban Affairs Committee. My name is Alan Krueger and I hold the Bendheim Professorship in Economics and Public Affairs at Princeton University. I appreciate the opportunity to share my views on recent economic developments, particularly as they relate to the labor market.

The Labor Market Situation and Short-Term Outlook

Although some debate the exact meaning of the subjective definition commonly used to define a recession, there is little doubt that the labor market started to turn down in the beginning of 2001, and that March 2001—the official beginning of the recession according to the National Bureau of Economic Research—marked a turning point. After reaching a 30 year low of 3.9 percent in April 2000, the unemployment rate fluctuated in a narrow range between 3.9 and 4.1 percent for the remainder of 2000, amid signs that economic growth was weakening.[1] The unemployment rate increased from 4.3 percent in March 2001 to 4.9 percent in August 2001, and reached a recent peak of 5.8 percent in December 2001. The rate fell to 5.6 percent in January and fell again in February to 5.5 percent.

Because, other things being equal, the unemployment rate increases when the discouraged workers decide to actively search for work, economists often prefer to examine employment growth from the establishment survey, and the employment-to-population rate from the household survey, in addition to the unemployment rate. These data tell a similar story. The employment-to-population rate reached an all-time high of 64.8 percent in April 2000, stood at 64.3 percent in March 2001, and fell to 63.4 percent as of August 2001. The employment rate continued to fall to 62.6 percent in January 2002, and increased to 63.0 percent in the latest employment report, which pertains to February 2002. Unlike the unemployment rate, the employment rate fell in January 2002, suggesting that the improvement in the unemployment rate that month resulted from labor force withdrawal rather than an increased rate of job finding. In February, the small decline in the unemployment rate and the rise in the employment rate both pointed in the same direction.

Total payroll employment peaked at 132.7 million jobs in March 2001, and was down to 132.4 million in August 2001. It fell to 131.2 million in January 2002, and increased by 66,000 in February, an amount that is close to the average monthly absolute revision to the series. (The January and February figures are preliminary and subject to future revisions.) In the 11 months since March 2001, the month the recession began, total employment has fallen by 1.4 million jobs. Private sector employment is down by 1.8 million jobs in this period. By comparison, 11 months after the 1991 recession began, private sector employment was down 1.5 million jobs, and total employment was also down 1.5 million jobs. So, looking over a comparable interval, job destruction was somewhat greater in the private sector in the latest recession than in the previous one. Employment continued to drift downward after the recovery began in March 1991, and reached bottom in February 1992, with private sector employment down a total of 1.8 million jobs from the peak and total employment down 1.6 million from the peak.

The latest GDP news suggests that the economy began to turn around late in 2001 and that the recession likely has ended. I think it will take more months of data before one can reach the conclusion that the labor market has reached bottom and is on the upswing, however. I also suspect that employment growth will remain sluggish for a time to come, especially for the less skilled. Employment and unemployment tend to be lagging indicators when the economy begins to improve. This point was made by Alan Greenspan in his prepared testimony before the House Committee on Financial Services on February 27. "Even if the economy is on the road to recovery," he said, "the unemployment rate, in typical cyclical fashion, may resume its increase for a time."

Historically, the lingering effects of high unemployment in the first stages of a recovery tend to be concentrated among the less skilled and minorities. This seems to be the case despite the fact that recessions are becoming more egalitarian in terms of who they affect.

Such a pattern was clearly evident in the early 1990's. When the recession officially ended in March 1991, the unemployment rate was 6.8 percent. The rate con-

[1] All reported estimates are seasonally adjusted, unless stated otherwise.

tinued to rise for another 15 months, however, and did not settle below 6.8 percent again until the end of 1993. Moreover, the unemployment rate rose from 12.3 to 13.5 percent for high school dropouts in the year after the recession ended, while for college graduates it held steady at 2.9 percent. The "jobless recovery" mainly involved the less skilled.

The current recession started out in a very unusual fashion. As the following table makes clear, from March to July of 2001, unemployment rose more for college graduates and those with some college education than it did for high school dropouts. Since July, however, unemployment has increased more for high school dropouts and high school graduates than for more highly educated workers, as is the usual pattern in a downturn. It is also worth noting that the unemployment rate ticked up for those with a high school degree or less last month, despite falling overall.

Table 1: Seasonally Adjusted Unemployment Rate by Education Age 25 and Older

Education	March 2001	July 2001	February 2002
Less than High School	6.8 percent	6.8 percent	8.3 percent
High School	3.8 percent	4.1 percent	5.3 percent
Some College	2.7 percent	3.1 percent	4.1 percent
BA or higher	1.9 percent	2.2 percent	2.9 percent

Source: Bureau of Labor Statistics.

A similar picture holds by race. From March to July of 2001 the unemployment rate increased from 3.7 to 4.1 percent for whites, and, uncharacteristically, fell from 8.4 to 8.1 percent for blacks. From July 2001 to February 2002, however, the rate increased from 8.1 to 9.6 percent for blacks, and increased more moderately, from 4.1 to 4.9 percent, for whites. The unemployment rate for Hispanics was also uncharacteristically stable in the beginning of the recession (standing at 6.2 percent in March and July), and then increased sharply to 8.1 percent by January 2002, before quixotically falling by a percentage point in February.

The broad nature of the first phase of the latest recession came as a surprise, but is consistent with the more-than-usual egalitarian tilt to the early 1990's recession, and probably resulted from the plunge in capital investment that apparently precipitated the downturn, the implosion of many dot-coms, and the fact that the cyclically sensitive manufacturing sector is much more skill intensive than it was 20 or 30 years ago. In any event, it is likely that the egalitarian phase is over.

There are many theoretical reasons to suspect that job growth would be slow at the beginning of the recovery.

First, at the beginning of a recovery employers are not sure if improved conditions will persist, so they expand work hours rather than hire new employees.

Second, many employers also "hoard" skilled workers (for example, particularly those with specific training) during a recession because if they let them go it would be costly to hire and train replacements when conditions improve. Neither of these reasons, however, accounts for why job growth is particularly sluggish for the less skilled when the economy begins to turnaround, which seems to regularly occur. In fact, because of labor hoarding of skilled workers one might expect that employers are relatively "overstaffed" with skilled workers when the recession ends, and would therefore be less likely to hire skilled workers.

Third, as Melvin Reder suggested in a 1955 article, in a downturn many employers raise skill requirements for a given job, rather than cut pay.[2] "Upskilling" of positions is common in a recession and probably at the beginning of a recovery as well. Consequently, the less skilled find their job options even more limited until demand picks up smartly, while skilled workers take positions further down the job ladder.

Finally, Lawrence Katz of Harvard suggests another reason: "Think of a recession as a time when firms reorganize." Reorganization tends to increase demand for skilled workers, who are more flexible, over less skilled workers. Furthermore, when companies introduce new technology as part of a reorganization they tend to hire skilled workers to operate the equipment and release unskilled workers whose jobs are made redundant.

To some extent, the lingering pattern of unemployment, especially among the less skilled, after growth resumes is probably inadvertently reinforced by interest rate cuts by the Federal Reserve. With a lag, rate cuts stimulate demand for new capital

[2] See Melvin W. Reder, "A Theory of Occupational Wage Differentials," *American Economic Review* 45(5), 1955, pp. 833–52.

and consumer durables. But this is a two-edge sword for workers. On the one hand, a general rise in economic activity increases the demand for all factors of production, including workers. On the other hand, because machinery is cheaper than it used to be, in many industries companies replace some workers with machines, or hire fewer workers than they otherwise would have, because the machines can do the work at lower cost.

Also notice that capital—especially high-tech equipment—and skilled labor are generally considered complementary inputs in production, while capital and unskilled workers are substitutes.[3] In other words, high skilled workers are hired to operate and service the new machines, while less skilled workers are let go because the machines can do their work.

This leads me to the conclusion that the best way to avoid another "jobless recovery" is by stimulating demand for less skilled workers and by raising the skills of the unemployed. I think the interest rate cuts and the recently passed accelerated depreciation allowance will stimulate demand for more highly skilled workers. In looking forward, I would recommend policies that would increase employment of less skilled labor, such as job training.

Another important aspect of the labor market concerns wages. Table 2 (at the end of this testimony) reports real hourly wages by decile of the wage distribution each year since 1973 based on Current Population Survey Data.[4] As is well-known, real wages fell considerably for lower paid workers from 1979 to the mid-1990's. (This table uses the BLS's new research series CPI to deflate wages, so the decline in real wages in the 1980's was not as great as it is with the conventional CPI deflator.) Real wage growth was very strong after 1996, however. Notably, most of the ground that was lost for those at the bottom in the 1979–95 period was regained in the last 5 years. The weakest wage growth in the last decade was for those in the middle of the distribution, a phenomenon that I previously called "the sagging middle."

Most research finds that real wages have moved slightly procyclically since 1970, although I agree with Katharine Abraham and John Haltiwanger that "the cyclicality of real wages is not likely to be stable over time."[5] The exceptionally low unemployment in the late 1990's, combined with two minimum wage increases, spurred the impressive wage growth in the second half of the 1990's, especially for the least paid workers.[6] In the latest downturn, nominal wage growth slowed down, but inflation slowed even more, so real wages continued to grow.[7] This factor has probably bolstered consumer spending, which was surprisingly robust during the downturn.

A rising tide continues to lift all boats, and the late 1990's provides ample evidence that strong economic growth greatly helps all segments of society. But the effect of a rising tide on employment does not appear to occur immediately. In the early 1990's, weak employment growth lingered long after the national economic tide began to rise. Moreover, research suggests that a given change in economic conditions has a more gradual effect on labor demand in a recovery than in a recession.[8] As Edward F. McKelvey, a Senior Economist at Goldman Sachs observed after the latest unemployment report, "It would be premature to say that there is going to be heavy net hiring soon."

Unemployment Insurance

Because I expect unemployment to linger at relatively high levels in the beginning of the recovery, I think it is important and appropriate that last week both Houses of Congress passed, and the President signed, a bill to extend unemployment insurance (UI) benefits for an additional 13 weeks.

But I think recent history highlights the importance of making additional reforms to make unemployment insurance a more efficient and more effective automatic stabilizer. First, the automatic triggers that temporarily turn on extended benefits

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[3] For a survey of evidence on capital-skill complementarity, see Daniel Hamermesh, *Labor Demand,* Princeton University Press, 1996. For evidence on high-tech equipment and skill upgrading see David Autor, Lawrence Katz, and Alan Krueger, "Computing Inequality: Have Computers Changed the Labor Market?" *Quarterly Journal of Economics,* 113(4), November 1998, pages 1169–1213.

[4] These data were kindly provided by Jared Bernstein.

[5] Abraham, Katherine and John Haltiwanger. 1995. "Real Wages and the Business Cycle." *Journal of Economic Literature* 33, no. 3, pp. 1215–64.

[6] See, e.g., Lawrence Katz and Alan Krueger, "The High-Pressure U.S. Labor Market of the 1990's," *Brookings Papers on Economic Activity.* 1999:1, pp. 1–87.

[7] See Jared Bernstein, "What Drove Low Wages Up in the 1990's?" Mimeo., Economic Policy Institute, 2002.

[8] See James R. Hines, Hilary Hoynes, and Alan B. Krueger. "Another Look at Whether a Rising Tide Lifts All Boats," *The Roaring Nineties: Can Full Employment Be Sustained,* edited by Alan B. Krueger and Robert Solow, New York: Russell Sage and Century Fund, 2001.

without Congressional action should be set at more realistic levels. The State triggers are connected to the insured unemployment rate; that is, the fraction of covered workers who receive benefits. The insured unemployment rate must exceed 5 percent for extended benefits to be provided, and must be 120 percent above the rate in the corresponding period in each of the prior 2 calendar years. Because insured unemployment has drifted down relative to the BLS's total unemployment rate, and because the natural rate of unemployment has declined, it is very unlikely that a State will automatically trigger extended benefits. In practice, the automatic triggers have become beyond reach, and we rely on Congress to vote for extended benefits during a downturn.

It should not be necessary for Congress to have to agree to *ad hoc* extended UI benefits when it is clear that the economy has deteriorated in a specific region. Realistic automatic triggers would be much more expedient and more efficient. Funds would be saved if extended benefits were more closely targeted to specific States experiencing severe economic distress, rather than applied nationwide. Furthermore, if extended benefits turned on more quickly in contracting areas, consumption would be smoothed and the downturn would be less severe.

Second, the financing of UI could do more to stabilize the economy and discourage layoffs. To pay for benefits, the UI system builds up reserves during prosperous times and draws them down during slack times. A common measure of the health of trust funds is the reserve ratio: The ratio of accumulated trust fund balances to annual payroll. A higher reserve ratio provides more protection in an economic downturn.

Unfortunately, the UI reserve fund in several States—most notably, New York and Texas—were quite low even before September 11.[9] Phillip B. Levine, an economist at Wellesley College, calculates that to remain solvent through a severe recession, like the one experienced in the early 1980's, unemployment insurance funds would require a reserve ratio of at least 1.25 percent.[10] Using this standard, 16 States were at risk of insolvency in a severe recession based on their reserve funds as of the first quarter of 2001. In New York the reserve ratio was 0.28 percent and in Texas it was 0.22 percent.

This predicament arose because many States did not build up their funds during the 1990's, and because experience rating—that is, the extent to which a business's payments increase with its past record of laying off workers—is poorly implemented. If the funds become insolvent, they will borrow from the Federal Government at close to market rates, and probably tighten eligibility standards to stem the shortfall. I would recommend considering that the States be required to implement real experience rating and maintain ample fund balances within 3 years (for example, after the economy improves sufficiently). This would shore up the long-run financing of the State programs. In addition, a study by Phillip B. Levine and David Card of U.C. Berkeley estimates that the unemployment rate would decline by six-tenths of a percentage point if industries were fully experience rated—that is, if employers in an industry were required to pay the full additional costs of unemployment benefits for layoffs in that industry.[11]

The Federal Government sets minimum standards for State unemployment insurance programs and has a history of encouraging experience rating. This is a unique aspect of the American system of UI, and may in part help to account for the relatively low unemployment in the United States compared to other economically advanced countries. Better experience rating could be accomplished by increasing the 5.4 percent maximum tax rate on high-layoff employers, and by requiring the States to have at least 10 different rates. Some States currently only have two rates: 0 or 5.4 percent. In addition, I would recommend that the per employee taxable earnings cap—which range from $7,000 to $10,000 in most States—be raised, which would allow better experience rating at lower tax rates and make the financing of the program less regressive. Raising the caps and lowering the rates would also increase demand for less skilled workers. Improved experience rating would discourage employers from laying off workers, and help to internalize the externalities layoffs impose on society.

Third, unemployed workers who are otherwise eligible for UI but are searching for a part-time job (that is, because of family obligations) are ineligible for benefits in most States. These workers pay into the system, but they are prevented from

[9] See Alan B. Krueger, Economic Scene; "Now is the time to reform unemployment insurance—before it is really needed." *The New York Times,* January 4, 2001, p. B2.

[10] Phillip B. Levine, "Cyclical Welfare Costs in the Post-Reform Era: Will There Be Enough Money?" Mimeo., Wellesley College, December 28, 2000.

[11] David Card and Phillip B. Levine, "Unemployment Insurance Taxes and the Cyclical and Seasonal Properties of Unemployment," *Journal of Public Economics,* vol. 53, February 1994.

receiving benefits. States could be required to expand eligibility. Workers who would be made eligible for UI benefits as a result of this reform would be primarily single-parent, female, and low-income workers.

I realize that Congress is likely to be reluctant to make additional changes to UI having just voted to expand benefit payments, but perhaps a commission could be established to study longer-term issues in UI, including the automatic triggers, financing, and eligibility requirements of the State programs.

Conclusion

Since the summer of 2001 the downturn has looked more like a typical downturn, with the labor market softening more for the less skilled and minorities than for highly educated, white workers. Recessions typically last longer and are more severe for the less skilled and minorities. Job growth early in a recovery is typically weaker for these groups as well. My guess is that the typical pattern will continue in the near future, but I have to confess a great deal of uncertainty as the recession initially was unusual in terms of the breadth of groups of workers affected. Additionally, the temporary help sector is much larger than it was in the early 1990's, and it is possible that employment adjustment over the business cycles will be quicker because the option of hiring from temporary help firms enhances labor market flexibility.[12] If this is the case, employment growth on the upswing may not lag economic growth as much as it has in the past. Nevertheless, it is probably more likely than not that higher unemployment will linger for less skilled and minority workers in the beginning of the recovery—and such a process has already begun if the recession ended in the fourth quarter of 2001.

To have a balanced recovery I would argue that policy has to be balanced as well. Fiscal and monetary policies are in place to lower the costs of capital and stimulate growth. Because of the phenomenon of capital-skill complementarity, this will likely increase demand for employment of skilled workers and reduce demand for employment of less skilled workers in the future. Policies are also in place (that is, extended UI benefits) to maintain consumption. To the extent that further policy initiatives are sought to stimulate job growth, I would expect that policies geared to stimulate demand for hiring less skilled workers would be most effective. Such policies could include job training, the Targeted Jobs Tax Credit, and a temporary reduction of payroll taxes. But I think it is also important to recognize that there will be pressures on the Federal budget as the baby boom cohort retires because of Medicare and Social Security commitments, so policies to address short-run cyclical adjustments should be careful not to weaken the long-run budget outlook.

[12] See, e.g., Lawrence Katz and Alan Krueger, "The High-Pressure U.S. Labor Market of the 1990's. *Brookings Papers on Economic Activity.* 1999:1, pp.1–87.

Table 2: Real Hourly Wages by Decile of the Wage Distribution (2000 Dollars)—DECILE:

Year	1	2	3	4	5	6	7	8	9
1973	$6.03	$7.28	$8.65	$10.06	$11.53	$13.23	$15.36	$17.57	$22.07
1974	5.96	7.15	8.49	9.83	11.26	12.96	15.02	17.31	21.84
1975	5.80	7.09	8.38	9.72	11.27	13.13	14.86	17.31	21.86
1976	6.25	7.26	8.44	9.76	11.34	13.20	15.13	17.59	22.11
1977	6.18	7.16	8.36	9.72	11.40	13.09	15.19	17.95	22.02
1978	6.27	7.40	8.62	10.05	11.77	13.50	15.59	18.42	23.09
1979	6.55	7.47	8.77	10.32	11.68	13.53	16.00	18.65	22.90
1980	6.19	7.32	8.59	9.97	11.55	13.43	15.59	18.47	22.62
1981	6.29	7.17	8.54	9.76	11.26	13.31	15.52	18.30	22.66
1982	6.06	7.06	8.44	9.82	11.44	13.35	15.72	18.52	22.93
1983	5.87	6.93	8.27	9.69	11.38	13.27	15.89	18.41	23.29
1984	5.74	6.97	8.22	9.67	11.45	13.31	15.78	18.78	23.64
1985	5.65	7.04	8.28	9.70	11.56	13.47	15.69	18.92	23.44
1986	5.64	7.21	8.52	10.05	11.78	13.83	16.19	19.13	24.17
1987	5.62	7.15	8.55	10.12	11.78	14.01	16.13	19.17	24.62
1988	5.63	7.10	8.50	10.12	11.71	13.92	16.22	19.35	24.81
1989	5.62	6.99	8.38	10.02	11.64	13.60	16.18	19.35	24.44
1990	5.70	7.06	8.47	9.98	11.63	13.48	15.99	19.24	24.55
1991	5.81	7.12	8.49	9.93	11.69	13.52	15.92	19.11	24.69
1992	5.79	7.05	8.43	9.85	11.78	13.45	15.93	19.24	24.33
1993	5.76	7.03	8.42	9.89	11.68	13.67	16.09	19.41	24.70
1994	5.70	6.96	8.27	9.70	11.47	13.51	16.05	19.54	25.12
1995	5.68	6.95	8.30	9.77	11.37	13.46	16.04	19.42	25.09
1996	5.65	7.00	8.38	9.78	11.31	13.36	16.09	19.45	25.16
1997	5.84	7.21	8.50	9.90	11.58	13.58	16.14	19.66	25.57
1998	6.16	7.44	8.71	10.36	11.91	14.00	16.65	20.07	26.31
1999	6.25	7.60	9.01	10.44	12.27	14.40	17.01	20.60	26.92
2000	6.31	7.77	9.08	10.51	12.26	14.51	17.19	20.91	27.50
2001	6.51	7.85	9.36	10.73	12.52	14.65	17.46	21.14	28.25

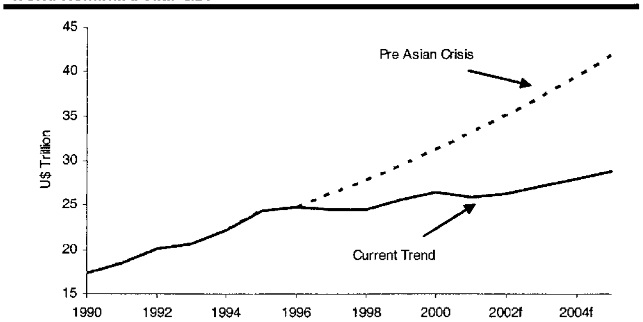
Source: Economic Policy Institute analysis of CPS data.
Note: Hourly wages were deflated by the BLS Research Series CPI deflator.

Statement of
David R. Malpass before the
Senate Banking Committee
March 12, 2002

Chairman Sarbanes, Senator Gramm, and members of the committee, thank you for the invitation to this hearing. My written statement covers the economic outlook; gives some thoughts on U.S. monetary and fiscal policy; and includes a final section dealing with some foreign economic issues.

As some of you know from my previous testimony before the committee, I am very interested in seeing higher living standards in developing countries and finding ways for the U.S. to support that process more effectively than we have in the past. One of the global economic features of the 1990s was the sharp increase in the U.S. share of world GDP. Part of this is a tribute to our economic system, but another part reflects the relatively poor economic performance in Japan and many developing countries. As we count our many blessings and work to make our own economy better for all, I think it is in our interest to also spend considerable time and attention working on an appropriate U.S. international economic policy.

World Nominal Dollar GDP



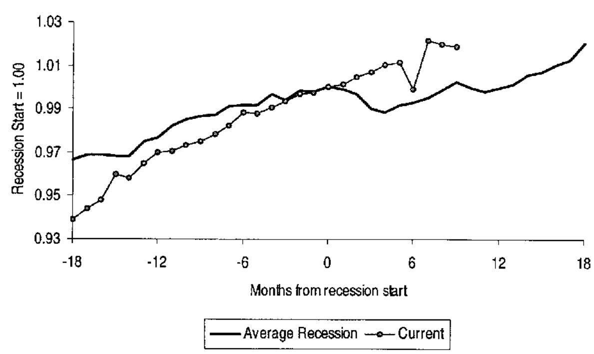
Source: Bear, Stearns & Co.

Economic Outlook

I expect a broad-based U.S. recovery in 2002, with support from consumption, inventories, government purchases, and second-half strength in business investment. The U.S economy's natural tendency is to grow. The latest improvement in the outlook is justified by solid U.S. strengths – strong productivity growth and relatively full employment. In recent months, Americans have shown their optimism and their patience when confronted with adversity, traits that I think auger well for the recovery.

After some recessions, growth accelerates to high levels early in the recovery due to pent-up demand. I don't expect that pattern in this recovery. Unlike previous recessions, consumption continued growing during the recession. It grew 2.5% in the second quarter of 2001, 1% in the third quarter due to the September drop (shown on the graph), and 5.3% in the fourth quarter (quarter-over-quarter, seasonally adjusted annual rates.)

Consumption: Current Vs. "Average Recession"



Source: Bloomberg; Bear, Stearns & Co. Inc

In many ways, the economy is reacting as if it is enjoying relatively full employment.

- For perspective, today's 5.5% unemployment rate compares very favorably to the 6.8% unemployment rate in March 1991 at the end of the last recession, and the 7.8% peak unemployment rate in June 1992.

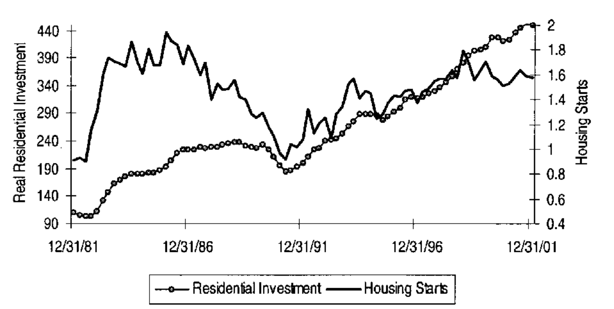
- Relatively full employment helps explain the growth in consumption during the 2001 recession.

- Of course, I would like to see the unemployment rate substantially lower. Given the strong productivity growth taking place, it's clear that the U.S. economy will again be able to enjoy a sub-5% unemployment without it being inflationary.

After some recessions, home prices and residential investment strengthen. This time, I expect some downward pressure on home prices – the impact of falling prices in other parts of the economy, lower prices for construction materials and labor, and a lagged effect from the very strong dollar (which puts downward pressure on almost all prices over time.) However, the downward pressure should be cushioned by strong fundamental factors, including tax incentives, the relative value of houses versus other investments, readily-available financing, demographics, and the economic recovery.

I expect residential investment to grow at only a 2% rate in the second half of 2002, after some weakness in the first half. I don't expect this sluggishness to have enough impact on unemployment to be a major factor in the strength of the recovery.

Housing Starts and Real Residential Investment



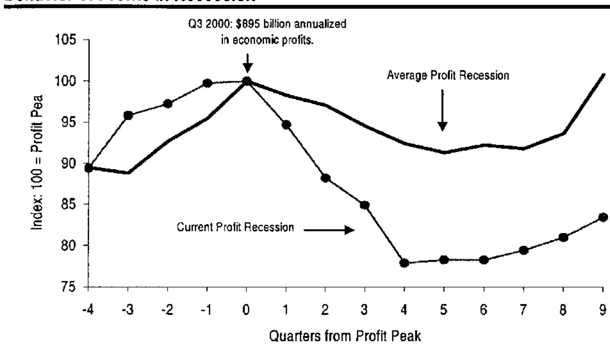
Source: Bloomberg; Bear, Stearns & Co. Inc

Even though the recession seems to be over, there are still intense pressures in the economy. I think they reflect the aftermath of a deflation caused by dollar strength in the late 1990s. We should see a piece-by-piece recovery unfolding, meaning that some industries, companies, and employee groups have absorbed the shock while others are still in its grip.

In my view, the intensity of the corporate adjustment is pushing the economy quickly through the deflation process, bringing it closer to completion. This ability to digest mistakes and move forward is one of the hallmarks of the American system of business and labor flexibility and is a key factor in our strong long-term growth.

Corporate earnings will probably remain under pressure due to the continuing downward pressure on prices and the weakness in nominal GDP growth rates, especially abroad. Unlike previous declines in corporate earnings, 2001 profitability was depressed by both recession and deflation. As a result, the drop of profits has been deeper and has lasted longer than the average of the seven previous "profit recessions".

Behavior of Profits in Recession

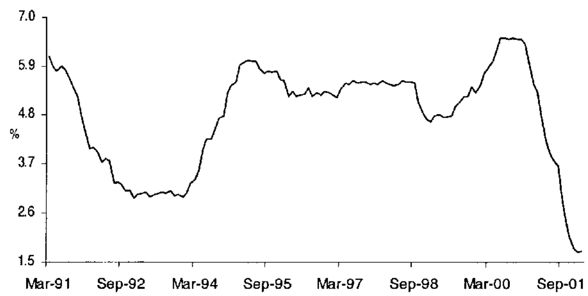


Source: U.S. Department of Commerce; Bear Stearns & Co. Inc.

Thoughts on monetary policy

As the U.S. recovery broadens, U.S. monetary policy will be faced with the questions: is growth itself inflationary and, if not, does it require a monetary policy response? In part responding to these questions, short-term interest rates have fluctuated over a relatively wide range in recent years.

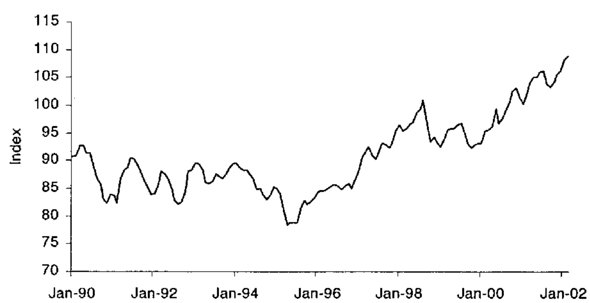
Effective Federal Funds Rate



Source: Bloomberg

My view is that inflation and deflation are more related to changes in the value of money than to economic growth. When a currency loses value, it puts upward pressure on prices. Likewise, when a currency rises in value, it puts downward pressure on prices. Since the dollar is very strong -- as judged by its trade-weighted value, its value versus commodity baskets and its value versus gold – I think there is more likely to be downward pressure on prices than upward pressure.

Dollar's Value vs. Trade Weighted Currency Basket



Source: Bloomberg

Even with a recovery, I think the CPI inflation rate will fall substantially in coming months, making an argument against a rapid increase in interest rates and bond yields. As a policy matter, I would like to see a more explicit recognition of the connection between the value of the dollar and the inflation or deflation rate. I think it is important for us to achieve stability in the value of the dollar as a step toward price stability.

Thoughts on fiscal policy

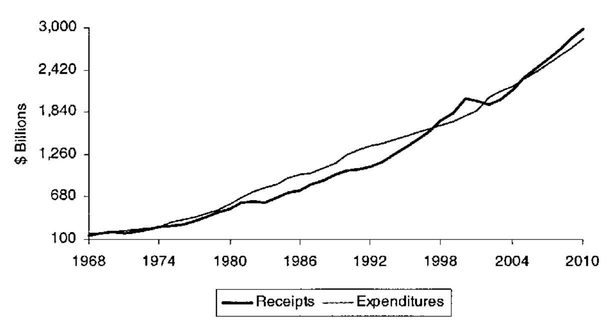
Fiscal policy is obviously a very complicated subject, both from an economic and a political perspective. I would like to offer some general thoughts:

In their recent budget forecasts, both OMB and CBO used conservative economic assumptions. Both assumed 2002 growth rates well below the likely outcome and back-loaded the growth to the second half of 2002. This had the effect of projecting a sizeable fiscal deficit for FY02, which ends in September. This was understandable given the perceived state of the economy at the time the budgets were prepared.

The budget now looks like it may be in surplus in FY02 and FY03 (and was already assumed to be in surplus in subsequent years.) This is the result of several factors: a shallower-than-expected recession in 2001; the remarkable change in interest rate policy in 2001; strong U.S. productivity growth, indicating a relatively high rate growth rate potential; and Congress's unusually well-timed tax cut in 2001.

The federal budget reflects tremendous growth in the spending and even faster growth in federal receipts. The graph below uses CBO's February forecasts for FY02.

Federal Receipts and Expenditures

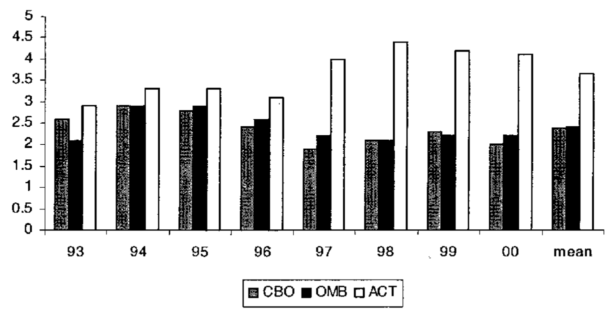


Source: CBO, Bear, Stearns & Co.

The budget outlook is very sensitive to growth assumptions. No one is very good at forecasting growth rates in either the near-term or long-term. The trend in the 1980s was to over-estimate growth and under-estimate the fiscal deficit. The trend in the 1990s was the reverse – to under-estimate growth and over-estimate the fiscal deficit. These trends applied to both public and private sector forecasters.

I think the latter situation – a tendency to underestimate the growth rate -- will be more applicable this year and next in that U.S. productivity growth will probably remain strong, the result of business and labor flexibility.

Real GDP Forecasts: OMB and CBO vs. Actual



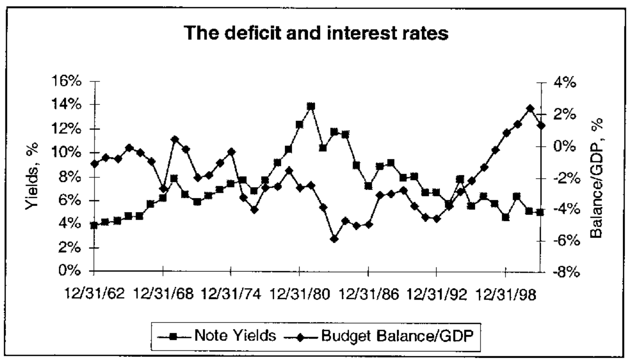
Source: CBO, Bear, Stearns & Co

Real GDP growth averaged 3.6% in the 1996-2001 period, including the 2001 recession. Given the shallowness of the 2001 recession and the ongoing strength in productivity, economic growth in coming years is likely to also be strong. Even if we use an average growth rate of 3% going forward, the cumulative fiscal surplus is still large, as is the rate at which the national debt would decline.

If economic growth is as solid as I expect, the glide path for the pay-down of the national debt will be rapid and would not be good economic policy. In effect, our current policy is to levy a stiff level of taxation on the workers and the profitable portion of the private sector to pay off relatively low-cost federal debt. The effect is to improve the federal government's balance sheet while putting pressure on the public's balance sheet.

Given the economic recovery, Congress will probably revisit the 1990s debate about what to do with the fiscal surplus. In my view, tax cuts would help maximize the economic growth rate and gains in median incomes as well. In addition, I think a fiscal surplus, if it emerges, should also provide an opportunity for an improvement in the social security system.

I would like to comment on one recent debate – the issue of whether a fiscal surplus causes lower interest rates. The evidence does not support this conclusion. The 10-year bond yield rose to 8% by early 2000, even as the budget moved toward a large surplus. Over the last year, expectations turned from surplus to deficit, yet bond yields declined for most of the year. In recent days, bond yields have risen sharply despite the growing possibility of fiscal surpluses. As the graph shows, there is no real correlation between the fiscal deficit and the level of bond yields. Instead, I think bond yields are related to the outlook for inflation, growth and the exchange rate.



<u>Thoughts on International Economic Policy</u>

I would also like to offer some comments on economic development abroad, something I have worked on extensively over the years.

The U.S. economic recovery is good news for foreign economies. It will probably spark a recovery in Europe and may even help Japan break out of its deflation spiral. Some developing countries will be able to participate in the global expansion, helping them raise their living standards.

However, I am worried about the polarization of the world economy, meaning the wide gap between the U.S. growth rate and growth rates abroad. With each new burst of U.S. growth in the 1990s, it became increasingly apparent that the U.S. was producing (and consuming) an increasingly large share of world output, reaching roughly 35% and climbing. In my view, it is important that developing countries grow faster and begin to narrow the gap in living standards. But very few are.

Over the years, I have advocated a rethinking of our international economic policy and the international financial institutions. I favor a vision of economic development based on stable currencies, lower tax rates, trade liberalization and a firm belief that people at the bottom of the economic ladder should be able to move up. I don't think these principles are applied frequently enough in our international economic policy. My worry is that world growth may remain substantially below its potential, with the shortfall coming disproportionately from the poor.

Conclusion

The likely U.S. economic recovery is very welcome, particularly given the war on terrorism and the turmoil in international affairs. The recovery provides an opportunity for thoughtful economic debate. My statement noted the importance of monetary policy decisions relating to growth and inflation; the fiscal policy decision in the event of renewed surpluses; and the opportunity for constructive change in our international economic policy.